Supreme Court, U.S.
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No. 04-172

IN THE

Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION,
CHASE MANHATTAN BANK, USA,
NATIONAL ASSOCIATION, as Indenture Trustees,
and DR. BEN S. BRANCH, Chapter 7 Bankruptcy Trustee,

Petitioners,

v.

HSBC BANK USA and JPMORGAN CHASE BANK,
as Indenture Trustees,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. When Congress enacted Section 510(a) of the Bankruptcy Code, 11 U.S.C. § 510(a), and provided therein for enforcement of subordination agreements according to "applicable nonbankruptcy law," did it mean to preserve the pre-Code judicial practice of applying a federal common law canon of contract interpretation known as the Rule of Explicitness, or did it mean to abrogate use of this federal canon and instead require use of state law interpretive rules?

2. If the latter, did the First Circuit — in direct conflict with the Eleventh Circuit — err in refusing to accept and apply the New York Court of Appeals' determination that the Rule of Explicitness is a part of New York state law?

PARTIES TO THE PROCEEDINGS BELOW

In the court of appeals, this matter was captioned *In re Bank of New England Corp. (HSBC Bank USA and JPMorgan Chase Bank, as Indenture Trustees v. Dr. Ben S. Branch, Trustee in Bankruptcy)*. Dr. Ben S. Branch, in his capacity as bankruptcy trustee, administers the bankruptcy estate of the Bank of New England Corporation, a Chapter 7 debtor. HSBC Bank USA and JPMorgan Chase Bank (together, the "Senior Indenture Trustees") are the indenture trustees under three senior debt offerings issued by the debtor. U.S. Bank National Association and Chase Manhattan Bank, USA, National Association (successor by merger with Chemical Bank Delaware) (together, the "Junior Indenture Trustees") are the indenture trustees under three junior debt offerings issued by the debtor.

The issue before this Court involves the bankruptcy trustee's request to distribute approximately $11 million from the debtor's bankruptcy estate to the Junior Indenture Trustees. Because the Senior Indenture Trustees objected, in the proceedings below, to the bankruptcy trustee's proposed distribution on the basis that the funds were properly distributable to themselves, the Junior Indenture Trustees and the bankruptcy trustee are denominated the Petitioners in this Court, and the Senior Indenture Trustees are denominated the Respondents.

CORPORATE DISCLOSURE STATEMENT

Pursuant to S. Ct. R. 29.6, Petitioners U.S. Bank National Association and Chase Manhattan Bank, USA, National Association (successor by merger with Chemical Bank Delaware), in their respective capacities as Junior Indenture Trustees, state, by their counsel, the following: (a) U.S. Bank National Association, successor by merger with U.S. Bank Trust National Association, is wholly owned by U.S. Bancorp, a publicly-owned company; (b) Chase Manhattan Bank, USA, National Association (successor by merger with Chemical Bank Delaware) is wholly owned by JPMorgan Chase & Co., a publicly-owned company.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners U.S. Bank National Association, Chase Manhattan Bank, USA, National Association (successor by merger with Chemical Bank Delaware), as Indenture Trustees, and Dr. Ben S. Branch, Chapter 7 Bankruptcy Trustee, respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit in this case.

OPINIONS BELOW

The opinion of the First Circuit (App. 1a-21a) is published at 364 F.3d 355. Its order denying rehearing *en banc* (App. 42a-43a) is unpublished. The opinions of the district court (App. 22a-33a) and bankruptcy court (App. 34a-41a) are published at, respectively, 295 B.R. 419 and 269 B.R. 82.

JURISDICTION

The court of appeals issued its opinion on April 13, 2004, and denied a timely-filed petition for rehearing *en banc* on May 5, 2004. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

11 U.S.C. § 510(a) provides:

> A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

STATEMENT

For thirty years, courts have recognized, and investors have relied upon, a federal common law canon of contract interpretation known as the Rule of Explicitness. *See Chemical Bank v. First Trust of New York, Nat'l Ass'n (In the Matter of Southeast Banking Corp.)*, 688 N.Y.S.2d 484, 487, 710 N.E.2d 1083, 1086 (N.Y. 1999) (acknowledging the Rule and noting that parties have "undoubtedly relied on [it] — their lawyers would have been quite remiss had they not — since recent case law, as well as a leading authority and many commentators have consistently recognized the continued vitality of the Rule") (citations omitted). The Rule of Explicitness permeates "a vast sea of subordination agreements . . . involving enormous sums of outstanding public debt." *Id.* Now, however, the decision of the First Circuit threatens to send a tidal wave of uncertainty through the settled financial expectations in that vast sea.

As described more fully below, the Rule of Explicitness is a guide for the interpretation and enforcement of subordination agreements. The First Circuit determined that the federal version of the Rule was displaced by the enactment of Section 510(a) of the Bankruptcy Code in 1978, even though Section 510(a) instructs courts to enforce subordination agreements in accordance with "applicable nonbankruptcy law" — a phrase which this Court has consistently construed to include both federal law (like the Rule) and state law (here, the law of New York). By first declaring the federal Rule of Explicitness a "dead letter," App. 3a, and then refusing to accept and apply the state law version of the Rule (even though expressly recognized as part of state law by the New York Court of Appeals), the First Circuit has rendered uncertain the terms of hundreds of billions of dollars of subordinated debt issues, the substantial majority of which — as in this case — are governed by New York law.

1. Both before and after the enactment of the Bankruptcy Code in 1978, bankruptcy law has been clear that an unsecured creditor cannot recover post-petition interest (interest which accrues after the date on which the debtor filed its bankruptcy petition) from the debtor. *See* 11 U.S.C. § 502(b) (directing the bankruptcy court to determine the amount of an unsecured creditor's claim "as of the date of the filing of the petition" and disallowing any claim "for unmatured interest"); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 246 (1989) (acknowledging "pre-Code rule that the running of interest ceased when a bankruptcy petition was filed"); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946) ("The general rule in [pre-Code] bankruptcy . . . has been that interest on the debtors' obligations ceases to accrue at the beginning of proceedings."). Thus, as between a debtor and its unsecured creditors, the amount of a debtor's indebtedness to such class is fixed as of the petition date.

Unsecured creditors may, however, agree *among themselves* — outside of the bankruptcy law limitations on what the debtor owes them — to reallocate the recoveries they receive from the debtor. By such agreement, a junior creditor agrees to forfeit its share of distributions from the bankruptcy estate until such time (if ever) that the senior creditor recovers an amount equal to the post-petition interest it cannot itself collect directly from the debtor. While these arrangements, which typically take the form of a subordination or intercreditor agreement, do not (indeed, by virtue of the Bankruptcy Code, *cannot*) increase the total amount *the debtor* must pay to its general unsecured creditors, they effect a reallocation of payments from one group of unsecured creditors to another.

Because the contractual reallocation of bankruptcy assets contravenes accepted bankruptcy principles regarding the suspension of post-petition interest to, and the equitable, *pro rata* allocation of bankruptcy assets among, unsecured creditors, pre-Bankruptcy Code courts called upon to enforce subordination agreements demanded that such agreements contain language sufficiently specific and express that a junior subordinated creditor would know with certainty whether it had, in fact, forfeited its right to recover its normal distributions pending payment of post-petition interest to the senior subordinated creditor. These requirements of specificity became embodied in the so-called Rule of Explicitness.

First denominated as such by the court in *In the Matter of Kingsboro Mortgage Corp.*, 379 F. Supp. 227 (S.D.N.Y. 1974),[1] the Rule of Explicitness provides that a subordination agreement will be enforceable only if it contains "precise, explicit and unambiguous"[2] language alerting junior unsecured creditors to the payment — to senior unsecured creditors, to fund their claims for post-petition interest — of monies to which the junior creditors would otherwise be

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1. The rule . . . that[,] before a right to 'post-petition' interest and a concomitant reduction in dividends to subordinated creditors may be recognized, 'the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-à-vis these parties,' is no more than *a rule of 'explicitness'*. . . .

379 F. Supp. at 231 (emphasis added) (citations omitted).

2. *Id.*

entitled from a debtor's bankruptcy estate. Over the three decades of its application, the Rule has been distilled to require a specific reference to "post-petition interest" in the governing subordination agreement before junior creditors will be required to forfeit their distributions to senior creditors. *See Chemical Bank v. First Trust of New York, Nat'l Ass'n (In re Southeast Banking Corp.)*, 179 F.3d 1307, 1310 (11th Cir. 1999) ("[W]e find it beyond question that the subordination language in the indenture agreements in this case, which requires 'payment in full' *without any specific reference to post-petition interest*, is insufficiently 'precise, explicit and unambiguous' on the topic of post-petition interest to satisfy the Rule of Explicitness.") (emphasis added); *Bankers Life Co. v. Manufacturers Hanover Trust Co. (In re Kingsboro Mortgage Corp.)*, 514 F.2d 400, 401 (2d Cir. 1975) (determining that "paid in full" was "insufficiently express to relate to post-bankruptcy interest" and that senior creditors were not entitled to post-petition interest where "the contract *does not explicitly refer to post-bankruptcy interest*") (emphasis added).

2. By enacting the Bankruptcy Code in 1978, Congress incorporated numerous preexisting judicial practices and rules into the Code's statutory provisions, as this Court has consistently recognized. *See Midatlantic Nat'l Bank v. New Jersey Dep't of Environmental Protection*, 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.") (citations omitted); *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 565 (1990) (Blackmun, J., dissenting) ("[T]he Court presumes that Congress intended to keep continuity

between pre-Code judicial practice and the enactment of the Bankruptcy Code in 1978.").

Among these provisions was Section 510(a), which codified the pre-Code enforcement of subordination agreements:

> A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

11 U.S.C. § 510(a). As is evident, Section 510(a) conditions the enforcement of subordination agreements on "applicable nonbankruptcy law," a phrase which appears in several provisions of the Bankruptcy Code and which this Court has construed to encompass both state and federal law. *Patterson v. Shumate*, 504 U.S. 753, 758 (1992) ("Reading the term 'applicable nonbankruptcy law' in § 541(c)(2) to include federal as well as state law comports with other references in the Bankruptcy Code to sources of law.").

Following the enactment of Section 510(a) in 1978, courts continued to apply and enforce the principles underlying the Rule of Explicitness. *See, e.g.*, *First Fidelity Bank, Nat'l Ass'n v. Midatlantic Nat'l Bank (In re Ionosphere Clubs, Inc.)*, 134 B.R. 528, 533-34 (Bankr. S.D.N.Y. 1991) (citing *In re Kingsboro Mortgage Corp.* and other cases and concluding that "*Kingsboro* retains its vitality and remains the controlling law in the Second Circuit"); *see also In re EnviroDyne Indus., Inc.*, No. 93 B 310, 1993 WL 566565, at *36 (Bankr. N.D. Ill. Dec. 20, 1993) (citing *In re Kingsboro Mortgage Corp.* and *In re Ionosphere Clubs, Inc.*, and confirming plan of reorganization providing for distribution

of post-petition interest payments to senior holders where governing indenture "explicitly provides for payment of post-petition interest to senior indebtedness").

3. In 1998, in *Chemical Bank v. First Trust of New York, Nat'l Ass'n (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998), the Eleventh Circuit was asked to determine whether subordination language requiring "payment in full," without reference to post-petition interest, satisfied the Rule of Explicitness. Although both the bankruptcy court and the district court had concluded — in accord with the cases noted above — that the enactment of the Bankruptcy Code in 1978 did not affect the Rule, a divided panel of the Eleventh Circuit determined that § 510(a) abrogated the Rule as a federal interpretive canon. The court first observed that Section 510(a) conditioned enforceability on "applicable nonbankruptcy law." It found no independent federal statutory law to inform its interpretation of the subordination agreements at issue, and it noted that the parties before it had not argued that the Rule originated in federal common law — a suggestion which the court said it would reject in any event, based on its belief that the enforcement of private party contracts in this context did not sufficiently implicate a "distinctive federal interest." *In re Southeast Banking Corp.*, 156 F.3d at 1121 and n.8. This left only the bankruptcy court's equitable powers as the source of the federal Rule, and the Eleventh Circuit read the text of § 510(a) — which refers to nonbankruptcy *law* — as evidencing a Congressional intent to break with prior practice. *Id.* at 1123 ("When compared with [other provisions expressly invoking historic equity powers], section 510(a)'s command to enforce subordination agreements according to the applicable nonbankruptcy *law*

can only be read as a clear and contemplated break with prior practice.") (emphasis in original) (footnote omitted).[3]

The Eleventh Circuit recognized, however, that a rule for interpreting subordination agreements could, consistent with § 510(a), be located in *state* law, and that the subordination agreements before it provided for the application of New York law. *Id.* at 1121. Cognizant of the importance of the inquiry, *id.* at 1125 ("[g]iven New York's role as the nation's financial capital and our intuition that a sizeable proportion of outstanding indenture agreements include clauses that invoke New York law, as well as the importance of standardization in indenture agreements generally"), and expressing its reluctance "to predict its resolution under New York law," *id.*, the Eleventh Circuit certified the following question to the New York Court of Appeals:

> What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?

Id.

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3. In dissent, Judge Fay noted this Court's requirement that there be an express statement or clear indication that Congress intended a bankruptcy law to revoke a judicially established principle (citing *Cohen v. de la Cruz*, 523 U.S. 213, 221 (1998), as well as other decisions), and found no such clear expression in § 510(a). *In re Southeast Banking Corp.*, 156 F.3d at 1126. He also noted the Rule of Explicitness was never mentioned in the legislative history, *id.*, worked in harmony with other Code provisions, had been upheld by several courts, and "is well known and accepted by those in the financial world," *id.* at 1127.

In response to this question, the New York Court of Appeals first observed that, in its view, the enactment of Section 510(a) had not displaced the Rule of Explicitness: "The 1978 revisions to the Bankruptcy Code did not change the general rule that creditors are not entitled to post-petition interest. Thus, considerations underlying the Rule of Explicitness survive." *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1087. The New York Court of Appeals then looked to its own previous decision in *Pavone Textile Corp. v. Bloom*, 302 N.Y. 206, 97 N.E.2d 755 (1951), which this Court affirmed as *United States v. Bloom*, 342 U.S. 912 (1952) (per curiam). *Pavone* involved a general rule prohibiting creditors from recovering post-assignment interest in the context of a general assignment for the benefit of creditors under state law. In response to claims by the United States and the State of New York for post-assignment interest, the New York Court of Appeals held that "the general rule as to post-assignment interest prevails in the absence of any statute *expressly* providing for such interest," and denied the interest claims. *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1087 (emphasis in that text) (quoting *Pavone Textile Corp.*, 97 N.E.2d at 757). Accordingly, the New York Court of Appeals reasoned, "[t]he parallel construction and application are reasonable to carry over to the instant certified question concerning New York contract law insofar as it controls or impacts upon the underlying dispute in the Federal courts." *Id.*

The New York Court of Appeals answered the certified question as follows:

> In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing

> the payment of a senior creditor's post-petition interest demand.

Id. at 1088. Based on this response, the Eleventh Circuit concluded that "New York law applies the Rule of Explicitness to subordination agreements," *In re Southeast Banking Corp.*, 179 F.3d at 1310, and held that the agreements before it did not satisfy the Rule, *id.*[4]

4. The instant controversy originates in a proposed payment to the Junior Indenture Trustees, as unsecured creditors of the bankruptcy estate of the Bank of New England Corporation (the "Debtor"), and (together with the Respondents) as parties to six separate debt issues offered by the Debtor in the years predating its bankruptcy filing.[5]

In May 2001, Dr. Ben S. Branch, the bankruptcy trustee for the Debtor's estate, sought authorization from the Bankruptcy Court[6] to distribute approximately $11 million to the Junior Indenture Trustees. At the time of this request, the Junior Indenture Trustees had not received any principal or interest payments from the bankruptcy estate, but the Respondents had already recovered all principal and pre-bankruptcy interest to

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4. Judge Fay concurred in the result, reiterating his view that the federal Rule of Explicitness had not been "abolished" as previously announced by the majority. 179 F.3d at 1311 (Fay, J., concurring). He also urged *en banc* consideration of that aspect of the majority's holding, but recognized that, since the appellees had prevailed, they would have "difficulty" in petitioning for such consideration. *Id.* at 1311 n.1.

5. The details of the debt issues involved are set forth in the opinions below. *See* App. 3a-4a and 35a-36a.

6. The Bankruptcy Court had jurisdiction over the bankruptcy trustee's distribution motion under 28 U.S.C. § 157.

which they were contractually entitled under the senior subordinated indentures to which they were parties. Nevertheless, Respondents objected to the bankruptcy trustee's proposed distribution, contending that certain subordination language (the "Subordination Provisions")[7] contained in the junior subordinated indentures entitled Respondents to recovery of post-petition interest before any payments could be made to the Junior Indenture Trustees.

The Junior Indenture Trustees argued that the Subordination Provisions, which contained no express reference to "post-petition interest," were insufficiently specific to satisfy the Rule of Explicitness. Applying the Rule, the United States Bankruptcy Court for the District of Massachusetts agreed that the Subordination Provisions were inadequate to overcome the Bankruptcy Code prohibition on the recovery of post-petition interest, and authorized the distribution to the Junior Indenture Trustees by the bankruptcy trustee. App. 40a-41a. The United States District Court for the District of Massachusetts affirmed, determining that the absence of a specific reference to post-petition interest was fatal to Respondents' recovery: "[F]or a claim to post-petition interest to survive the Rule of Explicitness, a subordination agreement must *specifically* reference the entitlement of the Senior Debt holders to such interest." App. 32a (emphasis added).

On appeal, although neither party before it, and neither court below, had questioned the vitality of the Rule, the First Circuit determined on its own that it had to "retreat to first

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7. The Subordination Provisions are set forth in the opinions below. *See* App. 5a; 23a-24a and 36a-37a.

principles." App. 7a. It then decreed the Rule of Explicitness "a dead letter," App. 3a, as a matter of federal law. While it recognized that "the phrase 'applicable nonbankruptcy law' *can* refer to either federal or state law," App. 10a (emphasis added), it "conclude[d] that the applicable nonbankruptcy law referred to in section 510(a) is state law (and, particularly, state contract law)." App. 11a. Then, despite its express recognition that the state's highest court had confirmed that the Rule *was* part of state law in *In the Matter of Southeast Banking Corp.*, *supra*, the First Circuit nevertheless determined that it was not required to follow the New York Court of Appeals because it had "announced a bankruptcy-only principle." App. 15a.[8] The First Circuit then proceeded to conduct its own survey of New York law and determined that it provided "compelling proof that the Rule of Explicitness is not part of New York's general contract law." App. 14a. Without any reference to the New York Court of Appeals' explicit reliance in *In the Matter of Southeast Banking Corp.* on its previous *Pavone* decision,[9] the First Circuit stated that "[n]othing in that decision [*In the Matter of Southeast Banking Corp.*] persuades us that the Rule of Explicitness is otherwise a part of the armamentarium of interpretive principles generally available to the courts under New York law." App. 15a. Accordingly, although it agreed with the lower courts that the indenture language before it

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8. "While a federal court must defer when the highest court of a state interprets the state's general contract law, no such deference is due to a state court's importation of a bankruptcy-specific rule into its own jurisprudence." App. 15a (citation and footnote omitted).

9. The New York Court of Appeals identified *Pavone* as the "precedential building block for our recognition of the applicability of the Rule of Explicitness to the instant controversy." *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1087.

did not unambiguously provide for the recovery of post-petition interest by the senior creditors, it held that, under its view of New York law, this fact was not decisive — as it would be if the Rule of Explicitness applied — but instead remanded the matter for trial to ascertain the parties' intent:

> New York law requires that this amphiboly be resolved through a contextual examination of the parties' intent. . . . [W]e are persuaded that resolution of the intent question cannot be accomplished by the simple expedient of examining the relevant paperwork, but, rather, requires differential factfinding. . . . [W]e remand for factfinding on the parties' intent vis-à-vis post-petition interest.

App. 19a-21a.

The First Circuit recognized that its refusal to follow the New York Court of Appeals — and to apply the Rule of Explicitness to the indentures before it — placed it in direct conflict with the Eleventh Circuit: "We acknowledge that this conclusion compels us to part ways with the Eleventh Circuit. We are always reluctant to foment a circuit split, but we have no principled alternative here." App. 16a.

5. The First Circuit denied rehearing and rehearing *en banc*, and this petition for a writ of certiorari now follows.

REASONS FOR GRANTING THE PETITION

The First Circuit's refusal to recognize and apply the Rule of Explicitness has unraveled three decades of bankruptcy jurisprudence, directly contravened a decision of its sister circuit, and usurped the authority of the New York Court of Appeals to act as the final arbiter of its own state law. Moreover, it has done all of this unnecessarily: the First Circuit's decision to read the Rule out of the Bankruptcy Code is at odds with this Court's consistent view, when called upon to construe provisions of the Code, that Congress meant to preserve pre-Code judicial practice absent express evidence of contrary Congressional intent.

Only this Court can resolve this morass, which has now become very important. When the Eleventh Circuit panel majority in *In re Southeastern Banking Corp.* declared § 510(a) to have abrogated the federal version of the Rule of Explicitness, the practical effect of its ruling was mitigated by its adherence to the New York Court of Appeals' declaration that the Rule was part of New York state law. Now, however, the First Circuit has concluded that the Rule is *not* part of New York state law, at least in a way that any federal court must — or even may — follow. The result is an intractable conflict that has thrown into doubt hundreds of billions of dollars worth of bond offerings, the interpretation and enforcement of which are governed by New York law, but which will now be differently enforced in federal courts in Boston than in those in Atlanta, with those in the remainder of the country — including New York — now completely uncertain whether they should follow the highest court of that state or the neighboring federal circuit regarding this point of law.

For these important reasons, set forth in more detail below, this Court should grant review.

1. The First Circuit's conclusion that the enactment of Section 510(a) of the Bankruptcy Code in 1978 "extinguished the Rule of Explicitness in its classic form," App. 3a, was its primary error, and it occurred because the court of appeals did not heed this Court's well-established interpretive rule that pre-Code judicial practice is to be regarded as preserved, absent specific contrary congressional intent.[10] This Court has routinely held that provisions of the Bankruptcy Code do not displace preexisting judicial practice unless Congress has made such an intent manifest. *See, e.g., Midatlantic Nat'l Bank v. New Jersey Dep't of Environmental Protection*, 474 U.S. at 501.

The preservation of pre-Code practice is particularly compelling where, as here, there is no mention in the congressional record of an intent to displace the practice. *See United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380 (1988) (noting that "[s]uch a major change in the existing rules would not likely have been made without specific provision in the text of the statute . . . [or] without even any mention in the legislative history"); *Kelly v. Robinson*, 479 U.S. 36, 47 (1986) (citing *Midatlantic* decision and noting Court's refusal "to hold that the new Bankruptcy Code *silently* abrogated another exception created by courts construing the old Act") (emphasis added); *see also United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 252 (1989) (O'Connor, J., dissenting) ("The rule of

10. As noted, neither the lower courts nor any of the parties to this proceeding ever questioned the continuing viability (and applicability) of the Rule of Explicitness.

Midatlantic is that bankruptcy statutes will not be deemed to have changed pre-Code law unless there is some indication that Congress thought that it was effecting such a change.").

Read in the light of this Court's longstanding interpretive rule, § 510(a) is thus properly seen as sanctioning the pre-Code practice, rather than abrogating it. Prior to the enactment of the Bankruptcy Code in 1978, bankruptcy courts were not affirmatively authorized, by statute, to enforce subordination agreements; they did so exclusively in reliance on their inherent equitable authority. *See In re Southeast Banking Corp.*, 156 F.3d at 1118 ("Before Congress enacted the 1978 Bankruptcy Code, which includes a statutory provision regarding the enforcement of subordination agreements, the courts enforced those agreements pursuant to their equitable powers."). As part of the exercise of this equitable authority, and to aid in the interpretation and enforcement of subordination agreements, bankruptcy courts developed the Rule of Explicitness (necessarily a "nonbankruptcy" rule, since it does not affect the bankruptcy estate). *See In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1087 ("The Rule of Explicitness evolved as an equitable principle of contract construction in Federal common law. . . ."). The Rule of Explicitness was adopted and confirmed by the Tenth, Second, and Third Circuits. *See Continental Illinois Nat'l Bank and Trust Co. of Chicago v. First Nat'l City Bank of New York (In the Matter of King Resources Co.)*, 528 F.2d 789, 791 (10th Cir. 1976) (refusing to award post-petition interest to senior lenders where the subordination provisions "make no specific reference to the question of post-petition interest"); *In re Kingsboro Mortgage Corp.*, 514 F.2d at 401 (concluding that post-petition interest

is "not recoverable by senior creditors out of dividends due from the estate to junior creditors, at least absent a structure of priorities among creditors by express provision in the subordination contract" and further noting that the contract at issue "does not explicitly refer to post-bankruptcy interest"); *In the Matter of Time Sales Fin. Corp.*, 491 F.2d 841, 844 (3d Cir. 1974) (to be enforceable, an agreement regarding post-petition interest "should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-à-vis these parties").

By enacting § 510(a), which provides that "a subordination agreement is enforceable in a case under this title," Congress made it clear that it sanctioned the bankruptcy courts' exercise of jurisdiction over the enforcement of such agreements. In addition, Congress approved the application of "nonbankruptcy" rules by providing that such agreements were to be enforced "to the same extent that such agreement is enforceable under *applicable nonbankruptcy law*." 11 U.S.C. § 510(a) (emphasis added). Although legislative history directly bearing on this choice of terms ("applicable nonbankruptcy law") is absent,[11] under this Court's "normal rule" of interpretation noted above, that fact cuts in *favor* of the continued validity of the Rule of Explicitness, not against it. Moreover, Congress is presumed to have been aware of preexisting judicial practice when enacting the Bankruptcy Code — a presumption which carries particular weight in light of the rule against post-petition interest, on which the

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11. There is no specific indication in the legislative history, for example, that Congress was using "law" in § 510(a) in some narrow, technical sense to distinguish it from "equity," as the Eleventh Circuit panel majority erroneously surmised. *Cf.* 156 F.3d at 1123.

corollary Rule of Explicitness itself was premised. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. at 246 (rejecting pre-Code practice before it as "not the type of 'rule' that we assume Congress was aware of when enacting the Code" but noting, instead, and by way of example of a rule Congress *was* aware of, the "pre-Code rule that the running of interest ceased when a bankruptcy petition was filed").

Contrary to the First Circuit's conclusion, therefore, the Rule of Explicitness was not displaced by the enactment of Section 510(a) but, rather, fits comfortably within Section 510(a)'s invocation of "applicable nonbankruptcy law," as leading authorities have recognized. *See* 4 Collier on Bankruptcy ¶ 510.03[3] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004) (describing Rule of Explicitness as "a federal common law equitable doctrine," noting that Section 510(a)'s statutory language "comports with prior law," and concluding that the statutory "reference to enforceability to the same extent as under applicable nonbankruptcy law imports *all* nonbankruptcy law defenses to the agreement") (emphasis added); Marcia B. Pine *et al.*, *The Treatment of Claims in Bankruptcy: An Outline in Retrospect*, 709 PLI/Comm 213, 305 (1995) ("Section 510(a) codifies a line of court decisions, rendered prior to the Code, that enforced the nonbankruptcy law and the intent behind contractual agreements between creditors notwithstanding otherwise overriding federal bankruptcy law."). Numerous bankruptcy courts have also recognized Section 510(a)'s codification of pre-Code case law. *See In the Matter of Holly's, Inc.*, 140 B.R. 643, 669 (Bankr. W.D. Mich. 1992) ("Section 510(a) codifies pre-Code case law in which the courts enforced [subordination] agreements."); *Mihalko v. Continental Bank and Trust Co. (In re Mihalko)*, 87 B.R. 357, 364 (Bankr. E.D. Pa. 1988) ("[510(a)] codifies results

reached in decisions construing the former Bankruptcy Act of 1898."); *Beatrice Foods Co. v. Hart Ski Mfg. Co., Inc. (In re Hart Ski Mfg. Co., Inc.)*, 5 B.R. 734, 735 (Bankr. D. Minn. 1980) (stating that Section 510(a) "codifies what was existing case law under the prior Bankruptcy Act").

2. The First Circuit's decision expressly contradicts the Eleventh Circuit's application of New York's state law version of the Rule of Explicitness in *In re Southeast Banking Corp.*, 179 F.3d 1307 (11th Cir. 1999). With identical subordination language,[12] the same governing state law, and the same definitive exposition of that state's law by the highest court of the state, the First Circuit nevertheless "part[ed] ways with the Eleventh Circuit," App. 16a, and refused to apply the Rule of Explicitness here. Moreover, in addition to conflicting directly with the Eleventh Circuit, the First Circuit's decision also contravenes pre-Bankruptcy Code case law developed by the Tenth, Second, and Third Circuits and still relied upon as good law. Not only have the *King Resources*, *Kingsboro* and *Time Sales* cases not been overruled since the enactment of Section 510(a), they continue to be cited as authority for the existence and application of the Rule of Explicitness. *See, e.g., In re Ionosphere Clubs, Inc.*, 134 B.R. at 533-34 (Bankr. S.D.N.Y. 1991) (acknowledging that "*Kingsboro* retains its vitality and *remains* the controlling law in the Second Circuit") (emphasis added); *see also In re Southeastern Banking Corp.*, 156 F.3d at 1127 (Fay, J., dissenting) (recognizing that the Rule of Explicitness was "upheld as good law by three different appellate courts").

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12. *See In re Southeast Banking Corp.*, 156 F.3d at 1117 n.5.

3. The First Circuit's refusal to acknowledge the Rule of Explicitness as part of New York state contract law, despite the express declaration by the New York Court of Appeals that the Rule *is* part of its state's law, impermissibly overrides the New York Court of Appeals' authority to define the parameters of its own state law. *Wainwright v. Goode*, 464 U.S. 78, 84 (1983) ("[T]he views of the State's highest court with respect to state law are binding on the federal courts"); *Hortonville Joint Sch. Dist. No. 1 v. Hortonville Educ. Ass'n*, 426 U.S. 482, 488 (1976) ("We are, of course, bound to accept the interpretation of [the state's] law by the highest court of the State."); *West v. American Tel. & Tel. Co.*, 311 U.S. 225, 236 (1940) ("[T]he highest court of the state is the final arbiter of what is state law [and] [w]hen it has spoken, its pronouncement is to be accepted by federal courts as defining state law. . . .").

The First Circuit's fundamental error in refusing to apply New York state law as articulated by New York's highest court is highlighted by reference to Justice Frankfurter's concurring opinion in *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946). In *Vanston*, Justice Frankfurter observed the "classic admonition to begin at the beginning," *id.* at 169, when confronted (in the context of a bankruptcy proceeding) with indenture language purportedly entitling certain creditors to collect "interest on unpaid interest" from the debtor's estate, *id.* at 159. He thus took issue with the majority's willingness to address what he regarded as the second step (whether a federal bankruptcy court should honor an interest-on-interest obligation) without determining whether "it is an obligation created by applicable State law" in the first instance. *Id.* at 170. He started with independent, preexisting state law principles:

> The existence of a debt between the parties to an alleged creditor-debtor relation is independent of

> bankruptcy and precedes it. Parties are in a bankruptcy court with their rights and duties already established, except insofar as they subsequently arise during the course of bankruptcy administration or as part of its conduct. Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And the law that fixes legal consequences to transactions is the law of the several States.

Id. at 169.

Accordingly, Justice Frankfurter concluded that the parties were entitled to assert a claim for interest on unpaid interest (and thus seek recovery of the same from the bankruptcy court) only if New York law conferred that right, as determined by the New York Court of Appeals: "In the circumstances, if the words of the indenture created an obligation, they did so only if the law of New York says they did. . . . *And the ultimate voice of New York law, [is] the New York Court of Appeals. . . .*" *Id.* at 171 (citations omitted) (emphasis added).

The First Circuit justified its refusal to follow expressly declared state law by opining that the Eleventh Circuit had certified an impermissible question to the New York Court of Appeals. App. 15a ("[T]he question that it put to the New York court was beyond that court's competence to answer"). This proffered excuse, however, reveals a fundamental misconception on the part of the First Circuit. A subordination agreement is a contract, governed by state law and, as such, subject to enforcement in a state court just as any other contract. Since a subordination agreement does not alter the

obligations of a debtor, it need not be enforced exclusively in *bankruptcy*, by a *bankruptcy* court, applying *bankruptcy* law. Accordingly, if no federal interpretive rule specially applies, a federal court called upon to enforce a subordination agreement must look to state law and, more particularly, to state law rules of contract interpretation. Since the Rule of Explicitness is a canon of contract interpretation designed to assist courts in the enforcement of subordination agreements, to the extent that New York state law recognizes the Rule — as it does, according to its own highest court — the First Circuit erred fundamentally in refusing to follow the Rule and apply it to the facts of this case.

4. Only this Court can correct the important conflict which the First Circuit has fostered, which conflict involves a topic of enormous practical significance in the financial world, as noted by the New York Court of Appeals. *See In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1086 (acknowledging "the practical effect that our answer to the certified question will have on a vast sea of subordination agreements not before us now in live cases or controversies, nor even within the framework of this . . . litigation, involving enormous sums of outstanding public debt"). In excess of $400 billion in subordinated bonds have been issued over the past decade,[13] a significant portion of which, as "intuited" by the Eleventh Circuit, "include clauses that invoke New York law." *In re Southeast Banking Corp.*, 156 F.3d at 1125; *see, e.g.*, Daniel J. Weiser & Allan Mouw, *The Basics of Debt Financing: Indenture Basics, Issues to Consider in Drafting Covenants and How to Conduct an Exxon Capital Exchange*

13. Thomson Financial, Subordinated Debt Issues 7/1/1994 - 7/26/2004, *from Database Search* "All North American Debt, exc. Mortgage" (D, PD, R144D*) available at Thomson Financial, (973) 622-5200* (July 27, 2004).

Offer, 1307 PLI/Corp 197, 230 (2002) (noting that "[a]lmost all public indentures and indentures effected privately with registration rights are governed by New York law"). If the First Circuit's decision is allowed to stand, federal courts in Boston and other financial centers within the First Circuit will be forced to follow the First Circuit's view of New York law, while federal courts in Atlanta and other financial centers in the Eleventh Circuit will be compelled to follow the New York Court of Appeals' view, with courts in other centers left to wonder which view to follow (and what to make of a denial of review of this case by this Court). *Cf. Vanston Bondholders Protective Comm.*, 329 U.S. at 172 (Frankfurter, J., concurring) (noting that "the bankruptcy clause of the Constitution [and] [t]he Constitutional requirement of [geographic] uniformity . . . is wholly satisfied when existing obligations of a debtor are treated alike by the bankruptcy administration throughout the country regardless of the State in which the bankruptcy court sits").

Moreover, as the New York Court of Appeals recognized, such uncertainty and conflict are of critical concern "especially with regard to commercial matters where reliance, definiteness and predictability are such important goals of the law itself, designed so that parties may intelligently negotiate and order their rights and duties." *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1086. Circuits throughout the country have recognized that the effective functioning of the capital markets depends on the uniform interpretation of indentures:

> Whereas participants in the capital market can adjust their affairs according to a uniform interpretation, whether it be correct or not as an initial proposition, the creation of enduring

> uncertainties as to the meaning of boilerplate provisions would decrease the value of all debenture issues and greatly impair the efficient working of capital markets.

Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982); *see also Broad v. Rockwell Int'l Corp.*, 624 F.2d 929, 943 (5th Cir. 1981) (en banc) ("A large degree of uniformity in the language of debenture indentures is essential to the functioning of the financial markets. . . ."); *In re Southeast Banking Corp.*, 156 F.3d at 1125 (11th Circuit quoting *Sharon Steel Corp.* and *Broad*, as above).[14]

All of these reasons, legal as well as pragmatic, call for this Court's review. They also call for that review to be granted now, to minimize the uncertainty and concomitant harm the First Circuit's decision is causing.

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14. It is thus no answer simply to say that the First Circuit's view will not necessarily upset the intent of the parties to such contracts. The Rule of Explicitness was developed to resolve interpretation questions as a matter of law, without the need for "differential factfinding," and it was on just such a prompt and predictable resolution that the parties — and the national financial markets — relied when valuing such instruments. Moreover, in the absence of the Rule, courts will be required (as the First Circuit itself instructed the Bankruptcy Court, on remand) to act as "triers of fact" to determine the parties' intent — a challenging exercise in any event, often compounded in the context of bond offerings, which may date back decades.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT DATED APRIL 13, 2004

UNITED STATES COURT OF APPEALS
For the First Circuit

No. 03-1321

IN RE BANK OF NEW ENGLAND CORP.,

Debtor.

HSBC BANK USA AND JPMORGAN CHASE BANK,
AS INDENTURE TRUSTEES,

Appellants,

v.

DR. BEN S. BRANCH,
TRUSTEE IN BANKRUPTCY, ET AL.,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

[Hon. Richard G. Stearns, *U.S. District Judge*]
[Hon. William C. Hillman, *U.S. Bankruptcy Judge*]

Appendix A

Before

Selya, *Circuit Judge*,
Coffin, *Senior Circuit Judge*,
and Smith,* *District Judge*.

April 13, 2004

SELYA, *Circuit Judge*. This is a case that straddles a crossroads formed by the intersection of federal and state law. It requires us to decide an issue of first impression in this circuit regarding the enforceability in bankruptcy of agreements that allow the subordination of certain indebtedness. Our decision partially contradicts the decision of the only other court of appeals to have grappled with this same set of questions, *see Chem. Bank v. First Trust of N.Y.* (*In re Southeast Banking Corp.*), 156 F.3d 1114 (11th Cir. 1998), and to that extent creates a circuit split.

The precise dispute between the parties focuses on the priority (if any) that attaches to payment of post-petition interest on indebtedness that benefits from the contractual subordination of other indebtedness. As the question has been framed by the litigants and the lower courts, the answer depends on whether the subordination provisions at issue comply with the Rule of Explicitness. So phrased, the question assumes the continued vitality of that rule. Because we doubt the accuracy of that assumption, we step back to the beginning and inquire into the basis for believing that the Rule of Explicitness remains alive and well.

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* Of the District of Rhode Island, sitting by designation.

That step places us at the head of a long and winding path. After traveling it, we conclude that the enactment of section 510(a) of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2586 (codified at 11 U.S.C. § 510(a)), extinguished the Rule of Explicitness in its classic form. We further conclude that states are not free to adopt rules of contract interpretation that apply only in bankruptcy. For purposes of this case, then, the Rule of Explicitness is a dead letter.

Faced with this reality, we proceed to analyze the effect of the subordination provisions under New York's generally applicable principles of contract law—principles that do not embody any canon that operates in the same manner as the Rule of Explicitness. That analysis reveals an ambiguity in the language of the subordination provisions. The resolution of this ambiguity requires an inquiry into the parties' intent. That inquiry is fact-based and the bankruptcy court has not made the necessary findings. Consequently, we vacate the judgment below and remand for further proceedings.

I. BACKGROUND

The underlying facts are largely undisputed. In its halcyon days, the Bank of New England (BONE) issued six separate series of debt instruments.[1] Clearly worded choice of law provisions tie the construction and interpretation of these instruments to the law of New York. Three of these offerings (the Senior Debt) are entitled to the benefit of

1. Two of these were actually issued by BONE's predecessors in interest, but this technicality in no way affects our analysis. Thus, we disregard it.

contractual subordination provisions. They include (i) a series of debentures bearing interest at 7.625% per annum, due in 1998, in the aggregate principal amount of $25,000,000; (ii) a series of debentures bearing interest at 8.85% per annum, due in 1999, in the aggregate principal amount of $20,000,000; and (iii) a series of notes bearing interest at a rate of 9.5% per annum, due in 1996, in the aggregate principal amount of $150,000,000. HSBC Bank USA and JPMorgan Chase Bank, appellants here, serve as Indenture Trustees for the Senior Debt. The remaining three offerings (the Junior Debt) are subordinated to the Senior Debt. They include (i) a series of floating rate debentures, due in 1996, in the aggregate principal amount of $75,000,000; (ii) a series of debentures bearing interest at 8.75% per annum, due in 1999, in the aggregate principal amount of $200,000,000; and (iii) a series of debentures bearing interest at 9.875% per annum, due in 1999, in the aggregate principal amount of $250,000,000. Each trust indenture referable to Junior Debt contains a subordination provision that is substantially similar to the following:

> [E]ach Holder likewise covenants and agrees by his acceptance thereof, that the obligations of the Company to make any payment on account of the principal of and interest on each and all of the Notes shall be subordinate and junior, to the extent and in the manner hereinafter set forth, in right of payment to the Company's obligations to the holders of Senior indebtedness of the Company.

Each of these indentures also specifies that:

Appendix A

> The Company agrees that upon . . . any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities, to creditors upon any dissolution or winding up or total or partial liquidation or reorganization of the Company, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, conservatorship or other proceedings, all principal (and premium, if any), sinking fund payments and interest due or to become due upon all Senior Indebtedness of the Company shall first be paid in full, or payment thereof provided for in money or money's worth in accordance with its terms, before any payment is made on account of the principal of or interest on the indebtedness evidenced by the [Junior] Notes due and owing at the time. . . .

On January 7, 1991, BONE filed a voluntary petition for bankruptcy. *See* 11 U.S.C. §§ 701-766. At that time, much of the Senior and Junior Debt was still outstanding. Everyone agrees that, in bankruptcy, the holders of the Senior Debt are contractually entitled to priority. Withal, the parties fiercely dispute whether that priority extends to the payment of post-petition interest.

Since filing for bankruptcy, BONE, under the careful stewardship of its Chapter 7 trustee, has made three distributions to creditors. Through these distributions, the bankruptcy estate has paid the holders of the Senior Debt the full amount of all unpaid principal and pre-petition interest, together with all approved fees and expenses

incurred through the date of the last distribution (October 26, 1999). The trustee then created an ample reserve for future fees and expenses and, at that point, concluded that he had satisfied the obligations owed to the holders of the Senior Debt. When, thereafter, the trustee determined that there existed sufficient unencumbered funds, he sought permission to make a distribution in the amount of $11,000,000 to the holders of the Junior Debt. The appellants objected on the ground that the trustee had not yet paid post-petition interest on the Senior Debt.

The bankruptcy court overruled this objection and authorized the proposed distribution. *In re Bank of New Engl. Corp.*, 269 B.R. 82, 86 (Bankr. D. Mass. 2001). The court based its decision on the Rule of Explicitness, holding that New York law recognized the rule and that the language of the subordination provisions failed to satisfy it. *Id.* at 85-86. The district court affirmed. *HSBC Bank USA v. Bank of New Engl. Corp. (In re Bank of New Engl. Corp.)*, 295 B.R. 419, 424-25 (D. Mass. 2003). The court's analysis differed somewhat from that of the bankruptcy court, but it too deemed the Rule of Explicitness controlling. *Id.* at 424. This appeal ensued.

II. DISCUSSION

We cede no special deference to the district court's initial review of the bankruptcy court's decision. *See Gannett v. Carp (In re Carp)*, 340 F.3d 15, 21 (1st Cir. 2003). Rather, we look directly to the bankruptcy court's decision, examining that court's findings of fact for clear error and its conclusions of law de novo. *Id.* Insofar as the bankruptcy

court's decision hinges on an interpretation of the Bankruptcy Code, it presents a question of law (and, thus, engenders de novo review). *United States v. Yellin (In re Weinstein)*, 272 F.3d 39, 42 (1st Cir. 2001).

As the litigants and the lower courts have framed the issue, the pivotal question is whether the language of the subordination provisions satisfies the Rule of Explicitness. We do not agree that this is the correct question. Thus, we retreat to first principles.

Subordination agreements are essentially inter-creditor arrangements. 4 Lawrence P. King et al., Collier on Bankruptcy ¶ 510.03[2], at 510-7 (15th rev. ed. 2003). They are designed to operate in a wide range of contingencies, one of which is insolvency. As a hedge against the ravages of a future bankruptcy, subordination agreements typically provide that one creditor will subordinate its claim against the debtor (the putative bankrupt) in favor of the claim of another creditor. This subordination alters the normal priority of the junior creditor's claim so that it becomes eligible to receive a distribution only after the claims of the senior creditor have been satisfied. *Id.* at ¶ 510.01, at 510-3.

Prior to 1978, the Bankruptcy Act contained no specific mention of subordination agreements. *See* Alan N. Resnick & Brad Eric Scheler, *The Right of a Senior Creditor to Receive Post-Petition Interest from a Subordinated Creditor's Distributions: Did the Rule of Explicitness Survive the Enactment of the Bankruptcy Code?*, 32 Uniform Comm. Code L.J. 466, 466 (2000). Accordingly, subordination provisions were enforced in bankruptcy through the bankruptcy court's

equitable powers. *See, e.g., Bankers Life Co. v. Mfrs. Hanover Trust Co. (In re Kingsboro Mortg. Corp.)*, 514 F.2d 400, 401-02 (2d Cir. 1975) (per curiam); *Matter of Time Sales Fin. Corp.*, 491 F.2d 841, 844 (3d Cir. 1974); *Bird & Sons Sales Corp. v. Tobin*, 78 F.2d 371, 373 (8th Cir. 1935). Enforcing such agreements was necessary to prevent junior creditors from receiving windfalls after having explicitly agreed to accept less lucrative payment arrangements. *See Matter of Credit Indus. Corp.*, 366 F.2d 402, 410 (2d Cir. 1966); *In re Hinderliter Indus., Inc.*, 228 B.R. 848, 853 (Bankr. E.D. Tex. 1999). Equity dictated enforcement because "[e]quality among creditors who have lawfully bargained for different treatment is not equity but its opposite." *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 848 (2d Cir. 1966).

Defining the outer limits of this equitable rule, especially with respect to post-petition interest, posed a thorny problem. Generally, the accrual of interest on an unsecured or undersecured claim stops upon the debtor's filing of a bankruptcy petition. *See, e.g., Nicholas v. United States*, 384 U.S. 678, 682 (1966); *Sexton v. Dreyfus*, 219 U.S. 339, 344 (1911); *see also* 11 U.S.C. § 502(b)(2); Bankruptcy Act of 1898, § 63(a). Yet, subordination agreements sometimes contain language that prioritizes (or, at least, arguably prioritizes) the payment of post-petition interest on senior indebtedness over any recovery on junior indebtedness. From the outset, courts have been uncomfortable with enforcing this type of prioritization for fear that cases would arise "where a senior creditor may potentially recover more under a subordination agreement than its allowable claim against the estate." 4 Collier on Bankruptcy, *supra* ¶ 510.03[3], at 510-8.

To ease this discomfiture, judges fashioned an equitable doctrine to deal with (and, essentially, limit) the prioritization of post-petition interest payments. *See* Resnick & Scheler, *supra* at 467-68. In its simplest form, this equitable doctrine, called the Rule of Explicitness, required that a subordination agreement show clearly "that the general rule that interest stops on the date of the filing of the petition is to be suspended." *Time Sales*, 491 F.2d at 844. Over time, this evolved into a requirement that only unequivocal language could overcome the generic bar on recovery of post-petition interest.

That was the state of the law when Congress enacted the Bankruptcy Code in 1978. Pub. L. No. 95-958, 92 Stat. 2549. Unlike the earlier Bankruptcy Act, the Code deals explicitly with subordination agreements. Section 510(a) provides that a subordination agreement is enforceable in bankruptcy to the same extent as under "applicable nonbankruptcy law." 11 U.S.C. § 510(a). This statutory provision supplants the judge-made doctrine through which the courts previously had dealt with such agreements. Because equitable powers possessed by bankruptcy courts "must and can only be exercised within the confines of the Bankruptcy Code," *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988), the enactment of section 510(a) means that the enforcement of subordination provisions is no longer a matter committed to the bankruptcy courts' notions of what may (or may not) be equitable. *First Fid. Bank v. Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.)*, 134 B.R. 528, 533 (Bankr. S.D.N.Y. 1991).

That Congress cabined the bankruptcy courts' equitable powers while providing an alternate means for preserving the viability of subordination agreements does not resolve the further question of whether the Rule of Explicitness, through some other medium, survived the enactment of section 510(a). To answer that query, we begin, as always, with the text of the relevant statute. *See 229 Main St. Ltd. P'ship v. Mass. Dep't of Envtl. Prot. (In re 229 Main St. Ltd. P'ship)*, 262 F.3d 1, 5 (1st Cir. 2001). We are mindful, of course, that the language of an unambiguous statute normally determines its meaning. *Id.*

In terms, section 510(a) provides that a "subordination agreement is enforceable in a [bankruptcy] case . . . to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). It is clear beyond peradventure that the phrase "applicable nonbankruptcy law" can refer to either federal or state law. *See Patterson v. Shumate*, 504 U.S. 753, 757-59 (1992). Since the construction of private contracts is usually a matter committed to state law, *Volt Info. Scis., Inc. v. Bd. of Trs.*, 489 U.S. 468, 474 (1989), the presumption is that state law will furnish the proper benchmark. That presumption is especially robust here because we can find no federal statute that might guide us in interpreting subordination agreements. *Accord Southeast Banking*, 156 F.3d at 1121.

Of course, it might be possible to argue for the use of federal common law in this context. But resort to a federal common law of contract enforcement ordinarily is justified only when required by a distinct national policy or interest. *See Bartsch v. Metro-Goldwyn-Mayer, Inc.*, 391 F.2d 150,

153 (2d Cir. 1968). The interpretation and enforcement of financial arrangements between private parties does not fill that bill. *See Southeast Banking*, 156 F.3d at 1121 n.8.

To be sure, there is an important federal interest in the uniform application of the bankruptcy law—but that interest will not suffice in this instance to justify resort to federal common law. By requiring that the enforceability of subordination agreements be subject to applicable nonbankruptcy law, Congress determined that such agreements should be interpreted using non-uniform principles. It is not our province to second-guess this determination. To cinch matters, the Supreme Court has instructed us that in the absence of specific statutory provisions to the contrary, property interests should not be analyzed differently as a result of a party's involvement in a bankruptcy case. *Butner v. United States*, 440 U.S. 48, 55 (1979). We take this to mean that bankruptcy courts should only modify the usual state-law compendium of rights and remedies if and to the extent that such modifications are specifically authorized or directed by the Bankruptcy Code.

For these reasons, we conclude that the applicable nonbankruptcy law referred to in *section 510(a)* is state law (and, particularly, state contract law). *Accord In re Best Prods. Co.*, 168 B.R. 35, 69 (Bankr. S.D.N.Y. 1994); 9E Am. Jur. 2d Bankr. § 3113 (2000). It follows inexorably that if the Rule of Explicitness retains any vitality, it does so only as part and parcel of state law. *See* 4 Collier on Bankruptcy, *supra* ¶ 510.03[3], at 510-9, 10 ("[T]he Rule of Explicitness cannot be found in the Code, but resort must be had to the state law governing the contractual subordination agreement."); *see also Southeast Banking*, 156 F.3d at 1124.

This brings us to the parameters of the authority delegated by section 510(a). One thing seems very clear: in keeping with the principle that bankruptcy is an area of distinct federal competence, Congress has conferred on the federal courts the power to apply any and all generally applicable state rules of contract interpretation in construing subordination agreements. But section 510(a) does not vest in the states any power to make bankruptcy-specific rules: the statute's clear directive for the use of applicable *nonbankruptcy* law leaves no room for state legislatures or state courts to create special rules pertaining strictly and solely to bankruptcy matters. *See In re Cross*, 255 B.R. 25, 34 n.5 (Bankr. N.D. Ind. 2000); *cf. Int'l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929) (clarifying that states are not free to enact laws that interfere with federal bankruptcy law or that provide additional or auxiliary regulation with respect to bankruptcy matters).

Formulation of the bankruptcy law requires Congress carefully to balance competing considerations. That effort is manifest here. On the one hand, bankruptcy highly values equitable distribution that is in line with the priorities embodied in the Code itself. On the other hand, equity typically operates to enforce voluntarily bargained-for positions (some of which may contradict the Code's normal priorities). Section 510(a) encapsulates Congress's reconciliation of this conflict. A state's creation of a bankruptcy-only rule of enforcement would outstrip the authority that Congress conferred (and, thus, upset the equilibrium that section 510(a) was designed to achieve). We conclude, therefore, that such a course is not open to the states.

If the Rule of Explicitness is an interpretive principle unique to bankruptcy, it offends this principle. *See Ionosphere Clubs*, 134 B.R. at 533 (suggesting that the old Rule of Explicitness cases may "be inconsistent with the Code's new mandate that subordination provisions be enforceable in bankruptcy to the same extent that they are enforceable under nonbankruptcy law"). A contrary holding—one that allowed a state to adopt a bankruptcy-only Rule of Explicitness—would require certain contractual provisions (those arguably entitling senior noteholders to the payment of interest becoming due at future dates) to achieve a heightened degree of clarity only if the effort to enforce them arose in bankruptcy rather than in some other context. Such a holding would go well beyond the intended reach of section 510(a).

The short of it is that the enforceability of subordination agreements in bankruptcy must be judged by reference to generally applicable state contract law. As it pertains here, this holding limits our consideration to the general principles of New York contract law. If—and only if—the Rule of Explicitness is such a general principle can it be given effect in this case.

The New York courts do not appear to have developed any rules of interpretation that apply specifically to subordination agreements. *See Best Prods.*, 168 B.R. at 69-70; *see also Finest Invs. v. Sec. Trust Co.*, 468 N.Y.S.2d 256, 258 (N.Y. Sup. Ct. 1983) (applying generic rules of construction to subordination clause); *cf.* N.Y.U.C.C. § 1-209 off'l cmt. 4 (stating that the "enforcement of subordination agreements is largely left to supplementary principles under Section 1-103," which codifies the application of the general law of contracts). Moreover, reported decisions from the New York state courts reveal only a

single mention of the Rule of Explicitness. *See Chem. Bank v. First Trust of N.Y. (In re Southeast Banking Corp.)*, 710 N.E.2d 1083, 1084-88 (1999) (a case which, for reasons that we shortly shall explain, does not help our inquiry). Although we are in something of an epistemological quandary—it is always difficult to prove a negative—the near-total absence of authority is compelling proof that the Rule of Explicitness is not part of New York's general contract law.

The decision in *Chemical Bank* does not alter this conclusion. The opinion in that case was a response to a question certified by the United States Court of Appeals for the Eleventh Circuit. Faced with the issue we confront today, that is, whether a subordination provision permitted the payment of post-petition interest ahead of junior indebtedness, the Eleventh Circuit certified the following question to the New York Court of Appeals: "What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?" *Southeast Banking*, 156 F.3d at 1125. In so doing, the Eleventh Circuit invited the state court to fashion a bankruptcy-specific rule—and it did so without any evidence that New York had incorporated anything resembling the Rule of Explicitness into its general law of contracts.

Having received the invitation, the New York Court of Appeals responded in kind. The court recognized that it was being asked to determine if New York should adopt the Rule of Explicitness as a "guiding interpretive principle of State contract dispute resolution" in bankruptcy cases. *Chem. Bank*, 710 N.E.2d at 1086. The court proceeded to embrace the rule

as a rule of construction *applicable only in bankruptcy. See id.* at 1088 ("In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand."). The specificity of the court's holding is apparent from its use of the term "post-petition interest"—a term of art applicable only in bankruptcy. We recognize that the *Chemical Bank* court was constrained by the Eleventh Circuit's statement of the certified question. But this constraint does not alter the fact that, in its holding, *Chemical Bank* announced a bankruptcy-only principle. Nothing in that decision persuades us that the Rule of Explicitness is otherwise a part of the armamentarium of interpretive principles generally available to the courts under New York law.

This illustrates our area of disagreement with the Eleventh Circuit. As framed, the question that it put to the New York court was beyond that court's competence to answer. While a federal court must defer when the highest court of a state interprets the state's general contract law, *see, e.g., Daigle v. Me. Med. Ctr., Inc.*, 14 F.3d 684, 689 (1st Cir. 1994), no such deference is due to a state court's importation of a bankruptcy-specific rule into its own jurisprudence.[2]

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2. Although state courts do have the power to interpret federal law, that is not what the New York Court of Appeals was asked to do. The Eleventh Circuit requested the New York court to enunciate a bankruptcy-specific principle of state law. *See Southeast Banking*, 156 F.3d at 1125-26.

That ends this aspect of our inquiry. There is simply no reason to believe that the New York courts would apply the Rule of Explicitness outside the bankruptcy context. Accordingly, the Rule of Explicitness cannot hold sway. To find otherwise would do violence to the language of section 510(a) and set state and federal law on a collision course.

Let us be perfectly clear. If a state, as part of its general contract law, enunciates an interpretive principle that applies to subordination agreements generally (e.g., "construe all subordination provisions strictly and enforce them only if the intent to subordinate is, on a particular set of facts, super-clear"), that principle would be enforceable under section 510(a).[3] In that event, rejecting the prioritization of post-petition interest in the absence of explicit language would be consistent with the general law of the state. Such a situation would not pose the same problem as does a state rule that applies only in bankruptcy.

We acknowledge that this conclusion compels us to part ways with the Eleventh Circuit. We are always reluctant to foment a circuit split, but we have no principled alternative here. The *Southeast Banking* court invited the New York Court of Appeals to craft a special bankruptcy-only canon of contract interpretation. *See* 156 F.3d at 1125. In our view,

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3. We recognize that the source of such an interpretive principle may be a state statute, a canon of construction enunciated by the state courts, or a rule of equity consistently applied. A bankruptcy court's adoption and enforcement of a state equitable principle is not the exercise of the bankruptcy court's own equitable powers, but, rather, an application of state law (and, thus, is a proper exercise of the authority conferred by section 510(a)).

that course of action misapprehends the reach and breadth of section 510(a).

We now proceed to apply New York's general principles of contract enforcement to the facts at hand. This exercise will allow us to ascertain the effect of the provisions at issue upon the post-petition interest priority claimed by the appellants. Typically, the first step is to determine whether the challenged provisions are subordination agreements within the meaning of section 510(a). 4 Collier on Bankruptcy, *supra* ¶ 510.03[2], at 510-7. That step is a formality here: these are subordination clauses, pure and simple.

We next must determine the meaning and effect of the subordination provisions. Initially, we ask whether the provisions are ambiguous with respect to the relative priority of the payment of post-petition interest on the Senior Debt. This is a question of New York law. *See W.W.W. Assocs., Inc. v. Giancontieri*, 566 N.E.2d 639, 642 (1990). The New York Court of Appeals has provided us with clear, if conventional, guidelines:

> Contracts are not to be interpreted by giving a strict and rigid meaning to general words or expressions without regard to the surrounding circumstances or the apparent purpose which the parties sought to accomplish. The court should examine the entire contract and consider the relation of the parties and the circumstances under which it was executed. Particular words should be considered, not as if isolated from the context,

> but in the light of the obligation as a whole and the intention of the parties as manifested thereby. Form should not prevail over substance, and a sensible meaning of words should be sought.

William C. Atwater & Co. v. Panama R. Co., 159 N.E. 418, 419 (1927) (citations and internal quotation marks omitted).

We take it as a given that a contract is ambiguous when its provisions are susceptible of two or more reasonable interpretations. *See Breed v. Ins. Co. of N. Am.*, 385 N.E.2d 1280, 1282 (1978); *Yanuck v. Simon Paston & Sons Agency, Inc.*, 618 N.Y.S.2d 295, 296 (N.Y. Sup. Ct. 1994). That is the case here. Although each word, taken in isolation, may have a reasonably definite meaning, we must examine these words collectively. *See Atwater*, 159 N.E. at 419. When we do, ambiguity surfaces.

The pertinent language requires full payment of "interest due or to become due" upon the occurrence of a number of events (including bankruptcy, insolvency, receivership, conservatorship, or "other proceedings"). The meaning of "interest due or to become due" seems obvious in the context of, say, a municipal bond: upon the occurrence of a triggering event, interest that has been earned but is not yet due to be paid becomes entitled to a priority.[4] Thus, the application of this group of words in the context of most triggering events is fairly straightforward. But bankruptcy—an event

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4. We provide an example. If interest accruing on a bond is paid every six months (e.g., February 1 and August 1) and a triggering event occurs on May 1, the contractual language provides that all interest earned from February 1 through May 1 is entitled to prioritization (even though that interest is not yet due).

specifically referenced in the subordination provisions—alters the equation. Bankruptcy provides a special system of legal rules that occupies the field upon the filing of a petition. One byproduct of this special set of rules is that all interest is considered due as of the filing date. *See* 11 U.S.C. §§ 101(5)(a), 502(b). Conversely, interest that normally would accrue after that date is generally not recoverable at all (at least, not recoverable from the debtor). *See id.* § 502(b)(2).

These special rules cloud the meaning of the phrase "interest due or to become due." On the one hand, those words reasonably can be interpreted to apply only to triggering events outside of the bankruptcy context (where they have an unambiguous meaning). On the other hand, those words reasonably can be interpreted—as the appellants exhort—to apply to all triggering events, including bankruptcy. In that context, however, the words have no clear meaning and a court faces further ambiguity in trying to determine their contours. After all, in most cases the phrase "due or to become due" simply refers to unmatured interest. At the time of a bankruptcy filing, however, there is no unmatured interest, so the clause may be interpreted either to carry the same "nonbankruptcy" meaning throughout or to take on a bankruptcy-specific meaning (which would cover post-petition interest). Because each of these interpretations seems plausible, we believe that the subordination provisions—as they apply in bankruptcy—are ambiguous. *Cf. Southeast Banking*, 156 F.3d at 1124 (finding the phrase "paid in full" ambiguous *in the context of bankruptcy proceedings*).

In fine, we find the words "due or to become due" lacking in certitude as to whether they actually provide for the payment of post-petition interest on the Senior Debt prior to any payment referable to the Junior Debt. New York law requires that this

amphiboly be resolved through a contextual examination of the parties' intent, taking full account of the surrounding facts and circumstances. *Ruttenberg v. Davidge Data Sys. Corp.*, 626 N.Y.S.2d 174, 178 (N.Y. Sup. Ct. 1995); *Yanuck*, 618 N.Y.S.2d at 296; *Tobin v. Union News Co.*, 239 N.Y.S.2d 22, 25 (N.Y. Sup. Ct. 1963). Discerning this intent ordinarily requires the adjudication of factual questions. *See Ruttenberg*, 626 N.Y.S.2d at 175; *Yanuck*, 618 N.Y.S.2d at 296; *see also Time Warner Entm't Co. v. Brustowsky*, 634 N.Y.S.2d 82, 82 (N.Y. Sup. Ct. 1995) (noting that factfinding generally will be necessary if the contract term at issue is "susceptible to varying reasonable interpretations"). A trial can be avoided only if the parties' intent is made manifest within the four corners of the contract itself. *Ruttenberg*, 626 N.Y.S.2d at 175-76.

In the case at bar, it is impossible to glean the parties' intent from the language and structure of the instruments alone. These documents evidence complex commercial transactions, and the matter is further complicated because the beneficiaries of the subordination provisions—the holders of the Senior Debt—are not parties to the agreements containing the subordination provisions (those agreements are directly appurtenant to the Junior Debt). Given these realities, we are persuaded that resolution of the intent question cannot be accomplished by the simple expedient of examining the relevant paperwork, but, rather, requires differential factfinding.[5] Because the bankruptcy

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5. To be sure, the backdrop of bankruptcy may inform the examination into the parties' intent. *See Dolman v. U.S. Trust Co.*, 157 N.Y.S.2d 537, 541-42 (N.Y. Sup. Ct. 1956) (noting the presumption "that the parties had [the law in force at the time of agreement] in contemplation when the contract was made," and that

(Cont'd)

court has not yet developed a record with this inquiry in mind, we remand for factfinding on the parties' intent vis-à-vis post-petition interest.

III. CONCLUSION

We need go no further. We hold that the Rule of Explicitness has no application in the context of bankruptcy where, as here, the state has not adopted the rule as one of general applicability. Consequently, we turn to generic principles of state law to interpret the contractual provisions at issue. Applying those principles, we find the subordination provisions ambiguous as to whether they provide for the priority payment of post-petition interest. This finding necessitates an examination into the intent of the parties—an inquiry which, in the circumstances of this case, entails questions of fact that must in the first instance be addressed by the bankruptcy court. We therefore vacate the decision of the district court and remand with instructions that the district court vacate the judgment of the bankruptcy court and remand the matter to that tribunal for further proceedings consistent with this opinion.

Vacated and remanded. All parties shall bear their own costs.

(Cont'd)

the contract generally will be "construed in light of such law"). Here, however, the effect of that tenet is uncertain absent further factfinding. *Cf. Time Warner Entm't*, 634 N.Y.S.2d at 83 (finding a regulatory definition of a term not determinative of its meaning in a contract where proof was adduced indicating that the parties intended an independent meaning).

APPENDIX B — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MASSACHUSETTS DATED FEBRUARY 3, 2003

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION NUMBER 01-12229-RGS

IN RE:

BANK OF NEW ENGLAND CORPORATION,

Debtor.

HSBC BANK USA, AS INDENTURE TRUSTEE, AND JP MORGAN CHASE BANK f/k/a THE CHASE MANHATTAN BANK, AS INDENTURE TRUSTEE,

Appellants

v.

BANK OF NEW ENGLAND CORPORATION,

Appellee

February 3, 2003

STEARNS, D.J.

On December 17, 2001, the Senior Debt holders of the bankrupt Bank of New England Corporation (BNEC), appealed a November 1, 2001 order of the Bankruptcy Court authorizing a distribution of assets from BNEC's estate to

the Junior Debt holders. Appellants maintain that no such distribution can be made before they are paid post-petition interest.

Prior to BNEC's spectacular collapse, it obligated itself to six separate issues of Indenture debt, totaling $705,972,000. Under the terms of the Indentures, the first three issues (the Senior Debt) were to have priority over the remaining three issues (the Junior Debt). Each of the Junior Debt Indentures contains an "Agreement to Subordinate." The Agreement states:

> each Holder likewise covenants and agrees by his acceptance thereof, that the obligations of the Company to make any payment on account of the principal of and interest on each and all of the Notes shall be subordinate and junior, to the extent and in the manner hereinafter set forth, in right of payment to the Company's obligations to the holders of Senior indebtedness of the Company.[1]

The Indentures also specifically acknowledge the priority rights of the Senior Debt holders in the event of bankruptcy.

> The Company agrees that upon . . . any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities, to creditors upon any dissolution or winding up or total or partial liquidation or reorganization

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1. The quoted text is from the Floating Rate note. The other two notes are materially identical.

> of the Company, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, conservatorship or other proceedings, all principal (and premium, if any) sinking fund payments *and interest due or to become due upon all Senior Indebtedness of the Company shall first be paid in full*, or payment thereof provided for in money or money's worth in accordance with its terms, before any payment is made on account of the principal of or interest on the indebtedness evidence by the [Junior] Notes due and owing at the time. . . .

(Emphasis added). The parties agree that the Senior Debt holders are first in line for the payment of principal and pre-petition interest. The only dispute is over post-petition interest.

BNEC declared bankruptcy in 1991. The Trustee of BNEC's estate, Dr. Ben Branch, having done a truly remarkable job of marshaling BNEC's assets, has paid the principal of the Senior Debt in full, together with all pre-petition interest, post-petition fees, and the Senior Debt holders' expenses.[2] On May 23, 2001, the Trustee sought permission from the Bankruptcy Court to distribute $11,000,000 from BNEC's estate to the Junior Debt holders. The Senior Debt holders objected, claiming priority entitlement to post-petition interest. On November 1, 2001, Chief Bankruptcy Judge William Hillman authorized the

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2. The Trustee has also established a reserve to pay any future legal fees and expenses of the Senior Debt holders.

distribution. In a written opinion, Judge Hillman held that the language of the Junior Debt Indentures guaranteeing the Senior Debt holders "payment in full" of "interest . . . due and owing" did not include post-petition interest. This appeal ensued.

At the hearing before the district court, the parties agreed that *de novo* review of Judge Hillman's Order is called for as there are no disputes of fact and the operative language of the Indentures is (at least in the eye of the beholder) unambiguous. *See In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 73 (1st Cir. 1995) (a district court is to review *de novo* a Bankruptcy Court's conclusions of law). If the court were, however, to conclude that Judge Hillman's decision was based on ambiguities in the language of the subordination agreement, the Junior Debt holders maintain that the "clearly erroneous" standard should be applied instead. While

> [t]he interpretation of a contract is generally a question of law and subject to . . . *de novo* review," *Network Pub. Corp. v. Shapiro*, 895 F.2d 97, 99 (2d Cir. 1990), this general proposition applies only when the language of the contracts is unambiguous. *Rothenberg v. Lincoln Farm Camp, Inc.*, 755 F.2d 1017, 1019 (2d Cir. 1985). When the language of the contract is susceptible to more than one reasonable interpretation, the interpretation of the contract is an issue of fact.

In re The Brunswick Hosp. Ctr., Inc., 156 B.R. 896, 899 (E.D.N.Y. 1993). Because I do not interpret Judge Hillman's decision to be based on any perceived ambiguity in the

language of the Indentures, but rather on his legal conclusion that the language used failed to satisfy the Rule of Explicitness, the *de novo* standard of review applies.[3]

The genesis of the dispute on appeal arises from the interplay between two seemingly contradictory provisions of the Bankruptcy Code. Under 11 U.S.C. § 502(b)(2), a creditor in a bankruptcy proceeding is not entitled to post-petition interest.

> (b) Except as provided . . . the court, after notice and a hearing, shall determine the amount of [a bankruptcy] claim in lawful currency of the United States as of the date of the filing of the petition, . . . except to the extent that—. . .
>
> (2) such claim is for unmatured interest.

Under 11 U.S.C. § 510(a), which was inserted into the Bankruptcy Code by Congress in 1978, "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

The enactment of section 510(a) precipitated a debate over whether Congress had intended to abrogate the equitable foundation on which the Bankruptcy Court had erected the

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3. The Rule of Explicitness "prevents a senior creditor from recovering post-petition interest from junior creditors unless the subordination agreement articulates the obligation in unusually express language." *In re Southeast Banking Corp.*, 156 F.3d 1114, 1118 (11th Cir. 1998) (*Southeast Banking I*).

Appendix B

Rule of Explicitness. The origins of the Rule are ably explained in *Southeast Banking I.*

> The overriding theme of bankruptcy law, both past and present, has been the equitable distribution of the debtor's remaining assets among creditors. . . . The courts, however, have permitted creditors to contract out of this system of pro-rata distribution by enforcing subordination agreements, whereby one creditor (the junior creditor) agrees that, in the event of a default or bankruptcy, another creditor (the senior creditor) will receive repayment in full before the junior creditor receives payment on its loans. . . . In enforcing subordination agreements, however, the courts have emphasized that the junior creditor's agreement to subordinate must be express. *See In re Credit Industrial Corp.*, 366 F.2d at 408.
>
> The issue of post-petition interest has led to a wrinkle in the enforcement and interpretation of subordination agreements. Given the often lengthy delay between the debtor's petition for bankruptcy and the date upon which a creditor can expect to receive any payment on the underlying obligation, post-petition interest can represent a significant amount of money. Under both pre-Code practice and the 1978 Bankruptcy Code, unsecured and undersecured creditors could not expect to receive interest on a bankrupt debtor's obligation that accrued after the date of the bankruptcy petition—

at least not from an insolvent debtor. *See* 11 U.S.C. § 502(b)(2) (instructing courts to determine the amount of a creditor's claim on the date of the petition and disallowing claims for "unmatured interest").

. . .

In a number of cases, senior creditors sought to avoid this result and recover post-petition interest—not from the debtor, but from the distributions made to junior creditors subject to subordination agreements. Citing the junior creditors' agreement to subordinate their right to repayment until the senior debt had been paid in full, senior creditors argued that even though bankruptcy law prevented their recovery of post-petition interest from the debtor, their loans had not been paid in full and, therefore, that they could demand payment from whatever distribution the junior creditors received from the debtor. In 1974, before Congress adopted the Bankruptcy Code, the Court of Appeals for the Third Circuit addressed this argument and concluded that a junior creditor could agree to subordinate its claim to a senior creditor's demands for post-petition interest, if the subordination agreement *explicitly* provided for such a result:

> "If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to

> subordinated creditors, the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-a-vis these parties."
>
> *In re Time Sales Fin. Corp.*, 491 F.2d 841, 844 (3d Cir. 1974).

> Significantly, however, the *Time Sales* court held that general language in the subordination agreement, establishing that the senior debt must be "paid in full" before payment on the junior debt, was insufficient to alert the junior creditor that it had agreed to subordinate its claims to the senior creditor's claims for post-petition interest. . . . A number of courts, when confronted with similar claims and subordination agreements, adopted the Third Circuit's approach and dubbed it the "Rule of Explicitness."

Id. at 1118-1120.

Ultimately, the Court in *Southeast Banking I* concluded that the enactment of section 510(a) had indeed abrogated the Rule "as the progeny of the bankruptcy courts' equity powers or as a federal canon of contract construction." *Id.*, 156 F.3d at 1124. To the extent that the Rule survived section 510(a), it do so only as a matter of State law.

> The language of section 510(a) . . . directs courts to enforce subordination agreements to the extent

> that the agreements are enforceable under "applicable nonbankruptcy law." 11 U.S.C. § 510(a). In another context, the Supreme Court has held that Congress's use of the phrase "applicable nonbankruptcy law" in the Bankruptcy Code refers to any relevant federal or state law. *See Patterson v. Shumate*, 504 U.S. 753, 757-759 (1992) (noting that nonbankruptcy law is broader than state law, a term Congress also used in the Bankruptcy Code). Unlike the *Patterson* case, which involved a relevant provision of federal legislation, however, the parties before us have identified no independent federal statute that might guide the interpretation of subordination agreements; nor have they argued that federal common law should govern the outcome of this case. This absence of relevant federal authority should not be surprising because the enforcement and "interpretation of private contracts is ordinarily a question of state law.") *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 60 n. 4 (1995) (quoting *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989)); *see also Butner v. United States*, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

Id. at 1121. (Extended citations and footnote omitted).

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The Indenture at issue in *Southeast Banking I*, as here, contained a New York choice of law clause. "Since our review of New York law revealed no intimation of what specific language (if any) the New York courts would require to put a junior creditor on notice regarding the significant risk of subordinating a debt to a senior creditor's claims for post-petition interest and post-petition fees and costs, we CERTIFIED this important question to the New York Court of Appeals." *Id.*, 156 F.3d at 1125-1126.[4]

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4. The precise question asked was: "What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?" *Id.*, 156 F.3d at 1125. One could argue that the question was the wrong one, and that what the Court meant to ask was not how the New York Court of Appeals defined the Rule of Explicitness, but whether it recognized the Rule at all. As the Eleventh Circuit noted earlier in *Southeast Banking I*, the contours of the Rule were well-established. Indeed, given the consensus achieved by the Rule, the Eleventh Circuit wondered "whether the New York courts would disturb the heretofore uniform treatment of this question, particularly given the evidence that the capital markets appear to have adjusted to the Rule of Explicitness." *Id.* at 1124. "Nevertheless," the Court continued, "since this is an important question of first impression for the New York courts, . . . we are reluctant to predict its resolution under New York law." *Id.* at 1125. Certainly, the Court of Appeals gave more attention to the second question than it did to the actual question asked by the Eleventh Circuit. The Court of Appeals introduced its discussion with the prefatory remark that "we [now] face up to whether New York should adopt [the Eleventh Circuit's] version of the Rule of Explicitness as a guiding interpretive principle of State contract dispute resolution in cases such as this." *In the Matter of Southeast Banking Corp.*, 93 N.Y.2d 178, 183 (1999).

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The New York Court of Appeals answered as follows: "In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand." *In the Matter of Southeast Banking Corp.*, 93 N.Y.2d at 186. This answer led the Eleventh Circuit to reaffirm its prior determination that "we find it beyond question that the subordination language in the indenture agreements in this case, which requires 'payment in full' without any specific reference to post-petition interest, is insufficiently 'precise, explicit and unambiguous' on the topic of post-petition interest to satisfy the Rule of Explicitness." *In re Southeast Banking Corp. II*, 179 F.3d 1307, 1310 (11th Cir. 1999).

The Junior Debt holders argue that on the basis of this exchange, it is clear that for a claim to post-petition interest to survive the Rule of Explicitness, a subordination agreement must specifically reference the entitlement of the Senior Debt holders to such interest. I agree.[5] There is nothing ambiguous about the word "explicit." It means "fully and clearly expressed or demonstrated; leaving nothing merely implied." *Random House Unabridged Dictionary; Second Edition* (1993). This is especially the case when one is dealing with a bankruptcy term of art like "post-petition interest,"

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5. The Senior Debt holders make a convoluted, clever, and ultimately unconvincing argument that the Court of Appeals never really answered the certified question but simply deferred to the Eleventh Circuit's determination that the language in the subordination agreement at issue (which was virtually identical to the language in this case) failed to satisfy the Rule of Explicitness.

whose meaning would not be apparent to an ordinary investor unschooled in bankruptcy law, much less thought to be comprehended in a terms as general as "payment in full" or "due and owing."[6]

ORDER

For the foregoing reasons, the Order of the Bankruptcy Court is *AFFIRMED.*

SO ORDERED.

s/ Richard G. Stearns
UNITED STATES DISTRICT JUDGE

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6. The Senior Debt holders argue that the phrase "interest due or to become due" can only refer to post-petition interest as it is the only interest that could "become due" after a bankruptcy (because post-petition interest is otherwise disallowed). While the argument is not devoid of logic, it is not explicit, but depends on inferences drawn from the judicial reconciliation of the conflict between section 502(b)(2) and section 510(a).

APPENDIX C — MEMORANDUM DECISION ON TRUSTEE'S MOTION FOR ORDER AUTHORIZING FOURTH INTERIM DISTRIBUTION OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MASSACHUSETTS DATED NOVEMBER 1, 2001

UNITED STATES BANKRUPTCY COURT
for the
DISTRICT OF MASSACHUSETTS

Chapter 7

No. 91-10126-WCH

In re:

BANK OF NEW ENGLAND CORPORATION,

Debtor

MEMORANDUM DECISION ON TRUSTEE'S MOTION FOR ORDER AUTHORIZING FOURTH INTERIM DISTRIBUTION

Dr. Ben S. Branch, Chapter 7 Trustee (the "Trustee") of Bank of New England Corporation ("BNEC" or "the Company") has moved for authority to make a fourth interim distribution in the amount of $11,000,000 to the creditors of the estate (the "Motion"). As to the recipients of this distribution, the Trustee avers:

> Pursuant to the contractual subordination provisions of BNEC's indentures, the Senior Bondholders have been paid in full. Accordingly,

> on the date of the Fourth Interim Distribution, all payments to which the holders of senior indebtedness would be entitled shall be paid to the Junior Indenture Trustees for distribution to the holders of BNEC's subordinated indebtedness.

Motion, ¶ 16.

HSBC Bank USA, as successor to Marine Midland Bank, N.A., and The Chase Manhattan Bank, as successor to Manufacturers Hanover Trust Company (collectively, the "Senior Indenture Trustees") filed an objection to the proposed distribution. U.S. Bank Trust National Association and Chemical Bank Delaware (collectively, the "Junior Indentures Trustees") joined in support of the Motion. After a hearing I took the matter under advisement and I now grant the Motion. The following constitute my findings of fact and conclusions of law in accordance with Fed. R. Bankr. P. 7052.

Facts

There are no substantive factual issues to be resolved; it is the application of the law to the undisputed facts which is in controversy. This recitation is derived primarily from the *Trustee's Reply Brief Supporting Motion for Order Authorizing Fourth Interim Distribution.*

BNEC filed this Chapter 7 case over ten years ago. Prior to filing, BNEC had issued six separate issues of indenture debt, aggregating $705,972,000 in principal amount. Three issues are entitled to the benefit of contractual subordination provisions, and will be described as the Senior

Debt. The remaining three issues (the "Junior Debt") contractually subordinate payment in accordance with the terms of their indentures (the "Junior Indentures").

Through prior interim distributions, the Trustee has paid to the Senior Debt all allowed claims for principal and pre-petition interest plus post-petition fees and expenses incurred through the date of the last such distribution. The Trustee has created a reserve to cover any future fees and legal expenses. He proposes to make the next interim distribution to the Junior Debt. In the Objection, the Senior Indenture Trustees assert that the distribution should be first applied to post-petition interest due on the Senior Debt.

Each of the Junior Indentures provides that it is governed by New York law and contains a provision virtually identical to the following, which is quoted from one such indenture:

> [E]ach Holder likewise covenants and agrees by his acceptance thereof, that the obligations of the Company to make payment on account of the principal and interest on each and all of the Notes shall be subordinate and junior, *to the extent and in the manner hereinafter set forth*, in right of payment to the Company's obligations to the holders of Senior Indebtedness of the Company. (emphasis added).

The "extent and manner hereinafter set forth" includes the following provision:

> The Company agrees that upon . . . any payment or distribution of assets of the Company of any

> kind or character, whether in cash, property or securities, to creditors upon any dissolution or winding up or total or partial liquidation or reorganization of the Company, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, conservatorship or other proceedings, all principal (and premium, if any), sinking fund payments and interest due on or to become due upon all Senior Indebtedness of the Company *shall first be paid in full*, or payment thereof provided for in money or money's worth in accordance with its terms, before any payment is made on account of the principal or interest on the indebtedness evidenced by the [Junior] Notes due and owning at the time. . . . (emphasis added).

Issue

The issue before me resolves itself into the meaning of the emphasized phrase "shall first be paid in full." If that language does not encompass post-petition interest, the Trustee's position is well taken and the present motion should be granted as presented. If it does have the added breadth, then the interim distribution should be authorized (no one disputes this) but payment would go to the Senior Indenture Trustees to the extent of post-petition interest, which appears to far exceed the amount proposed for distribution.

Discussion

The outcome of this controversy will depend upon the application of the so-called Rule of Explicitness to the

language used in the Junior Indentures. That principle is generally traced to *Bankers Life Co. v. Manufacturers Hanover Trust Co. (In re Kingsboro Mortgage Corp.)*, 514 F.2d 400 (2d Cir. 1975), where the issue was the same as now before me. The language before the court in that case was strikingly similar to that quoted above:

> In the event of any insolvency, bankruptcy liquidation, reorganization or other similar proceedings . . . then all principal and interest on all Senior Debt *shall first be paid in full* . . . before any payment on account of principal or interest is made upon the Notes (junior indebtedness).

514 F.2d at 401 (emphasis added).

The Court of Appeals held that the quoted language "is insufficiently express to relate to post-bankruptcy interest." *Id. See also In re Time Sales Fin. Corp.*, 491 F.2d 841, 844 (3d Cir. 1974) ("If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to subordinated creditors, the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-a-vis these parties.")

At that time, of course, the operative law was the Bankruptcy Act, but its § 63(a)(1),[1] like the present law's

1. "Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidence by a judgment or an instrument in writing, absolutely owing at the (Cont'd)

§ 502(b)(2),[2] denied creditors post-petition interest. Missing from the Act, however, was a provision comparable to the Bankruptcy Code's § 510(a): "A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

The addition of § 510(a) led to a debate as to whether the Rule of Explicitness had been overruled. A scholarly examination of that issue can be found in *Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998). Finding itself in doubt, the Eleventh Circuit certified the following question to the New York Court of Appeals:

> What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?

Id. at 1125.

(Cont'd)
time of the filing of the petition by or against him, whether then payable or not, with any interest thereon which would have been recoverable at that date. . . ." 11 U.S.C. § 63a (Repealed).

2. (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that . . . (2) such claim is for unmatured interest. . . ." 11 U.S.C. § 502(b)(2).

Appendix C

The New York Court of Appeals responded that

> In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand.

Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.), 93 N.Y.2d 178, 186, 710 N.E.2d 1083, 1088 (1999).

The Senior Indenture Trustees oppose application of the stated principle to the present case. They argue that the New York Court of Appeals decision was based upon that conclusion of the Eleventh Circuit that "paid in full" was ambiguous, and that, based upon non-bankruptcy New York precedents, the term would require payment of interest until the date of the payment of all principal. *Objection*, ¶ 17. They further urge that the words "due or to become due" satisfy the New York law requirement for specific language. *Objection*, ¶ *18*. I am not persuaded by either argument.

As to the former, the Senior Indenture Trustees stop short of the actual reasoning of the New York Court of Appeals. While it noted the "binding threshold ruling" of the Eleventh Circuit that "paid in full" is ambiguous in the context of the pertinent subordination agreements, 688 N.Y.2d at 486, 710 N.E.2d at 1085, it continued:

> For the purposes of answering the particular question posed to us, we are confined by key

> features of the Eleventh Circuit's ruling. Nevertheless, we face up to whether New York should adopt its version of the Rule of Explicitness as a guiding interpretive principle of State contract dispute resolution in cases such as this.

Ibid.

It is in the latter context—establishment of a general principle of state law—that the court spoke.

As to the latter argument, the imposition of bankruptcy truncates the power of the contractual "due or to become due" phrase. Interest will no longer become due. 11 U.S.C. § 502(b)(2).

An order will enter granting the Motion.

s/ William C. Hillman
William C. Hillman
Chief Judge

Dated: 11/01/01

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT DENYING PETITION FOR REHEARING ENTERED MAY 5, 2004

UNITED STATES COURT OF APPEALS
For the First Circuit

No. 0-1321

IN RE: THE BANK OF
NEW ENGLAND CORPORATION

Debtor

HSBC BANK USA, as Indenture Trustee;
JP MORGAN CHASE BANK,
f/k/a Chase Manhattan Bank, N.A.

Appellants,

v.

THE BANK OF NEW ENGLAND CORPORATION;
CHEMICAL BANK DELAWARE;
US BANK TRUST NATIONAL ASSOCIATION;
DR. BEN S. BRANCH, Trustee

Appellees.

Before

Boudin, *Chief Judge*,
Coffin, *Senior Circuit Judge*,
Torruella* and Selya, *Circuit Judges*,
Lynch, Lipez and Howard *Circuit Judo*,
William E. Smith**, *District Judge*.

---

* Judge Torruella is recused and did not participate in the consideration of this matter.

** Of the District Of Rhode Island, sitting be designation.

Appendix D

ORDER OF COURT
Entered: May 5, 2004

The panel of judges that rendered the decision in this case having voted to deny the petition for rehearing and the suggestion for rehearing en banc having been carefully considered by the judges of the Court in regular active service and a majority of said judges not having voted to order that the appeals be heard or reheard by the Court en banc,

It is ordered that the petition for rehearing and the suggestion for rehearing en banc, be *denied*.

By the Court:
RICHARD CUSHING DONOVAN, Clerk

By: s/ MARK R. SYSKA
Chief Deputy Clerk.

No. 04-172

SEP 7 - 2004

In The Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION, CHASE MANHATTAN BANK, USA, NATIONAL ASSOCIATION, as Indenture Trustees, and DR. BEN S. BRANCH, Chapter 7 Bankruptcy Trustee,

Petitioners,

v.

HSBC BANK USA and JPMORGAN CHASE BANK, as Indenture Trustees,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The First Circuit

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Section 510(a) of the Bankruptcy Code directs the bankruptcy court to enforce subordination agreements under "applicable nonbankruptcy law." Before the Code's enactment in 1978, some federal courts had crafted an equitable bankruptcy rule by which they awarded post-petition interest to a senior creditor only if the subordination agreement expressly allowed such interest. Did this equitable bankruptcy rule survive the Code's command to apply "nonbankruptcy law" to subordination agreements?

2. New York adopted a bankruptcy-only rule governing payment of post-petition interest under subordination agreements. Did the First Circuit err by holding that this bankruptcy-only rule is not "nonbankruptcy law" under Section 510(a) of the Bankruptcy Code?

RULE 29.6 STATEMENT

Respondent HSBC Bank USA, N.A. is wholly owned by HSBC Holdings plc, a publicly-owned company. Respondent JPMorgan Chase Bank is wholly owned by J.P. Morgan Chase & Co., a publicly-owned company.

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BRIEF IN OPPOSITION

Respondents HSBC Bank USA, N.A. and JPMorgan Chase Bank respectfully submit that the petition should be denied. Only two courts of appeals have addressed the primary question of federal law presented here, and they have both agreed that the plain language of the Bankruptcy Code abrogated the pre-Code judge-made equitable Rule of Explicitness governing payment of post-petition interest under subordination agreements. The only disagreement between the First and Eleventh Circuits concerns which rule of New York contract law to apply, an uncommon and unimportant question that was correctly decided below. Moreover, the interpretive issue concerning the proper reading of subordination provisions found to be ambiguous may easily be avoided by clearer drafting. Finally, the decision below is interlocutory; as a result, the dispute between the parties in this case could well be obviated by the fact-finding ordered by the First Circuit on remand.

STATEMENT OF THE CASE

Petitioners' statement omits and misstates information concerning the factual and legal background of this case.

1. A subordination agreement is a contract that ranks the claims of creditors of a common debtor such that a (junior) creditor subordinates his claim to the (senior) creditor's claim. Thus, the debtor must pay the senior creditor in full before it pays the junior creditor anything. Subordination agreements are enforceable in and out of bankruptcy. Pet. 7a. The questions presented in this case – both of which concern whether the senior creditors are

entitled to recover interest accruing after the bankruptcy petition was filed prior to payment of the claims made by junior creditors – arise only in the narrow circumstance where the bankruptcy estate has sufficient assets to pay all of the principal and pre-petition interest due to the senior creditors, but insufficient assets to pay all principal and interest due the junior creditors as well as post-petition interest owed to the senior debt holders.

a. Before Congress enacted the Bankruptcy Code in 1978, the Bankruptcy Act of 1898 did not mention subordination agreements. Pet. 7a. Accordingly, some bankruptcy courts adopted judge-made equitable rules to determine whether subordination agreements would be enforced in bankruptcy. *See, e.g., In re Time Sales Fin. Corp.*, 491 F.2d 841, 844 & n.10 (3d Cir. 1974). In general, these courts concluded that equity demanded enforcement of such agreements because junior creditors, who freely agreed to subordinate their claims, would receive a windfall absent enforcement. *See, e.g., In re Credit Indus. Corp.*, 366 F.2d 402, 410 (2d Cir. 1966).

But these courts also worried that granting *post-petition* interest to senior creditors might confer a windfall upon them. Because interest generally does not accrue on unsecured claims after the debtor files a bankruptcy petition, a creditor may claim only principal and pre-petition interest against the estate. *See* Pet. 8a-9a. If a subordination agreement covered post-petition interest as well, the senior creditor thus would receive (from the junior creditor) more than its allowable claim against the estate. To ensure that both creditors intended this result, these courts crafted an equitable Rule of Explicitness to govern claims for post-petition interest. Under this rule,

which was an exception to the general rule against post-petition interest, these courts interpreted subordination agreements to cover post-petition interest only if an agreement expressly allowed such interest. Pet. 9a; *In re Time Sales*, 491 F.2d at 844. This Court, however, never addressed the rule's validity.

b. The enactment of the Bankruptcy Code in 1978 changed this regime. Unlike the Bankruptcy Act, the Code expressly addressed the treatment of subordination agreements in bankruptcy. Section 510(a) states that subordination agreements are enforceable in bankruptcy "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Thus, subordination agreements are now enforced in accordance with the statute, not pursuant to judge-made equitable rules.

Petitioners claim that, "[f]or thirty years," courts have consistently recognized and applied the "federal common law canon of contract interpretation known as the Rule of Explicitness." Pet. 2. To the contrary, before the decision below, the question whether Section 510(a) abrogated the ancillary equitable Rule of Explicitness has arisen in only one other court of appeals decision in the quarter century since the Code's enactment. *See Chemical Bank v. First Trust of N.Y. (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998). Like the First Circuit in this case, the Eleventh Circuit held that the plain language of Section 510(a) replaced the judge-made Rule of Explicitness with "applicable nonbankruptcy law." The court reasoned that Section 510(a) "cut away the equitable mantle under which the bankruptcy courts had fashioned the Rule of Explicitness." *Id.* at 1122. Further, the court explained that the bankruptcy court may exercise equitable

power only where authorized by the Code, and the Code did not grant that power for enforcing subordination agreements. *Id.* at 1122-23. Thus, the court concluded that the rule "can no longer survive as the progeny of the bankruptcy courts' equity powers or as a federal canon of contract construction." *Id.* at 1124.

At the same time, the Eleventh Circuit recognized that state law, as "applicable nonbankruptcy law," might have a similar interpretive rule, but it could not determine whether New York, whose law governed the agreements, had such a rule. *Id.* The Eleventh Circuit therefore certified the following question to the New York Court of Appeals: "What, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?" *Id.* at 1125. The New York Court of Appeals answered: "In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand." *Chemical Bank v. First Trust of N.Y. (In re Southeast Banking Corp.)*, 93 N.Y.2d 178, 186, 710 N.E.2d 1083, 1088, 688 N.Y.S.2d 484, 489 (1999). The Eleventh Circuit then held that the subordination agreement at issue did not satisfy this rule and denied the senior creditors' claim for post-petition interest. *Chemical Bank v. First Trust of N.Y. (In re Southeast Banking Corp.)*, 179 F.3d 1307, 1310 (11th Cir. 1999).

2. This case arises from Respondents' right to payment, on behalf of senior debt holders, of post-petition interest. While solvent, the Bank of New England N.A. issued senior and junior debt. Pet. 3a-5a. Petitioners U.S.

Bank and Chase Manhattan Bank, USA, N.A. are indenture trustees for the junior debt holders, while Respondents are indenture trustees for the senior debt holders. Pet. 4a.

After the Bank of New England filed its bankruptcy petition in 1991, Petitioner Ben Branch, the bankruptcy trustee, assumed control of its estate and made three payments to creditors. Pet. 5a-6a. From these payments, the senior creditors recovered their unpaid principal and pre-petition interest, as well as all of their fees and expenses. Pet. 5a-6a. Believing he had paid the senior creditors in full, the trustee proposed to pay $11 million to the junior creditors. Pet. 6a. Respondents objected to the payment on the ground that the subordination agreement entitled the senior creditors to payment of post-petition interest prior to any distribution to the junior debt holders. Pet. 6a.

The bankruptcy court overruled Respondents' objection and authorized the payment. Pet. 34a-41a. Because the indentures have a New York choice-of-law clause, the court held that the indentures do not satisfy the Rule of Explicitness announced in the New York Court of Appeals' *Chemical Bank* decision. Pet. 37a-41a. The district court affirmed on essentially the same grounds. Pet. 22a-33a.

3. The First Circuit vacated and remanded. Pet. 1a-21a. Like the Eleventh Circuit, the First Circuit concluded that Section 510(a) abrogated the pre-Code equitable Rule of Explicitness. Pet. 7a-10a. The court further agreed that state law is the appropriate source of "applicable nonbankruptcy law" in this situation, and thus looked to New York law. Pet. 10a-11a.

The First Circuit, however, held that the New York Court of Appeals' *Chemical Bank* decision is not "applicable nonbankruptcy law" under Section 510(a). Pet. 12a-16a. The court reasoned that *Chemical Bank* announced "a rule of construction *applicable only in bankruptcy*," as "is apparent from its use of the term 'post-petition interest' – a term of art applicable only in bankruptcy." Pet. 15a (quoting *Chemical Bank*, 710 N.E.2d at 1088) (emphasis in original). The court held that New York lacked the authority to create this bankruptcy-only rule, for "section 510(a) does not vest in the states any power to make bankruptcy-specific rules: the statute's clear directive for the use of applicable *nonbankruptcy* law leaves no room for state legislatures or state courts to create special rules pertaining strictly and solely to bankruptcy matters." Pet. 12a (emphasis in original).

The court emphasized the limited scope of its holding: it stands ready to enforce, under Section 510(a), any "interpretive principle" that a state legislature or state court "applies to subordination agreements generally," so long as it is not "a state rule that applies only in bankruptcy." Pet. 16a. This limitation necessarily arises from the express command that subordination agreements be enforced "to the same extent that such agreement[s are] enforceable under applicable *nonbankruptcy* law." 11 U.S.C. § 510(a) (emphasis added).

Accordingly, the First Circuit applied New York's general contract law, and found that the subordination agreements in this case were ambiguous regarding the availability of post-petition interest. Pet. 17a-20a. In accordance with settled New York contract law, the court held that "resolution of this ambiguity requires an inquiry into the parties' intent. That inquiry is fact-based and the

bankruptcy court has not made the necessary findings." Pet. 3a. The court therefore remanded for further proceedings. Pet. 3a.

REASONS FOR DENYING THE WRIT

1. The First Circuit and the Eleventh Circuit are unified on the primary question presented: whether Section 510(a) abrogated the pre-Code equitable Rule of Explicitness. No other court of appeals has even addressed the question, and the two that have done so have decided it correctly. This question therefore does not warrant further review.

a. Section 510(a) gave new statutory authority to the bankruptcy court to enforce subordination agreements. As Petitioners concede, bankruptcy courts enforced subordination agreements before 1978 under their general equitable powers. Pet. 16. Section 510(a), however, directed bankruptcy courts to enforce these agreements only "to the same extent" that they are "enforceable under applicable nonbankruptcy law."

This instruction revoked the bankruptcy court's equitable power to enforce subordination agreements and replaced it with statutory authority to enforce such agreements only to the extent they are enforceable under "applicable nonbankruptcy law." Pre-Code equitable rules ancillary to the enforcement of subordination agreements like the Rule of Explicitness have necessarily been abrogated as well, for they simply are not "applicable nonbankruptcy law." This Court has held that the bankruptcy court possesses only those equitable powers expressly granted by the Code. "[W]hatever equitable powers remain in the

bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). As both the First and Eleventh Circuits recognized, Section 510(a)'s silence on equitable authority not only revokes pre-existing equitable authority, but also rules crafted under it – like the Rule of Explicitness. Pet. 9a (quoting *Norwest*); *Southeast*, 156 F.3d at 1122 (same).

Moreover, Congress knew how to grant equitable authority to the bankruptcy court when it wanted to do so. In Section 510(c), for example, Congress authorized the bankruptcy court to subordinate any claim "under principles of equitable subordination." 11 U.S.C. § 510(c). This subsection "powerfully demonstrates" that when Congress intended to preserve the bankruptcy court's pre-Code equitable powers, it said so expressly. *Southeast*, 156 F.3d at 1123. In this context, "section 510(a)'s command to enforce subordination agreements according to the applicable nonbankruptcy law can only be read as a clear and contemplated break with prior practice." *Id.*

Section 552(b)(1) further illustrates that Congress preserved pre-Code equitable powers in certain specified instances, but not in Section 510(a). Under that section, a lien covering after-acquired property may also cover post-petition proceeds as permitted by "applicable nonbankruptcy law," but the bankruptcy court may exclude such proceeds "based on the equities of the case." 11 U.S.C. § 552(b)(1). This section demonstrates that Congress did not grant any equitable power by the term "applicable nonbankruptcy law." Had that phrase included equitable power, it would not have been necessary for Congress to authorize the court to modify "nonbankruptcy law" based on "the equities of the case" in Section 552(b)(1) – the

phrase "applicable nonbankruptcy law" would have granted such power itself. Given that Section 510(a) does not similarly authorize the court to modify nonbankruptcy law based on "the equities of the case," the court necessarily lacks such power and must follow "applicable nonbankruptcy law."

Petitioners' contrary interpretation would effectively read the words "applicable nonbankruptcy law" out of the statute. Consider, for example, a State that enacts a statute prohibiting entirely the enforcement of subordination agreements. Under the plain language of Section 510(a), subordination agreements governed by the law of such a State would not be enforceable. Yet, Petitioners would have the bankruptcy court continue to enforce such agreements under the pre-Code judge-made equitable rules without regard to the dictates of "applicable nonbankruptcy law."

Having abrogated the pre-Code equitable Rule of Explicitness, Section 510(a) replaces it with state law. The phrase "applicable nonbankruptcy law" may refer to either state or federal law. *Patterson v. Shumate*, 504 U.S. 753, 757, 759 (1992). In this case, all agree, no nonbankruptcy federal statute applies, and in accordance with the usual rule, the interpretation and enforcement of private contracts is committed to state law. *See Volt Info. Scis., Inc. v. Board of Trs.*, 489 U.S. 468, 474 (1989). The First and Eleventh Circuits agree that no distinctive federal interest justifies creating a federal common law of subordination agreements in bankruptcy. Pet. 10a-11a; *Southeast*, 156 F.3d at 1121 n.8. Nor have Petitioners identified any need for a federal rule of decision. Indeed, they have conceded that state law governs subordination agreements outside bankruptcy. Pet. 21-22. Under the plain language of

Section 510(a), state law governs them in bankruptcy as well.

b. Faced with Section 510(a)'s plain text and uniform interpretation in the courts of appeals, Petitioners resort to a negative inference from the absence of legislative history. Under this Court's precedents, they argue, the Code should be interpreted to incorporate prior practice absent an express statement in the Code or its legislative history disavowing pre-Code practice. Pet. 15-18. But Petitioners have overstated the relevance of pre-Code practice, which this Court uses only as an aid to interpret *ambiguous* text. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) ("where, as here, the statute's language is plain, . . . reference to legislative history and pre-Code practice is hardly necessary") (internal citation omitted). Because Section 510(a) is unambiguous, the bankruptcy courts' pre-Code practice cannot alter its meaning.

Petitioners cite two cases in which this Court relied upon pre-Code practice, but neither stands for the proposition that a pre-Code, judge-made rule overrides explicit statutory language. Pet. 15 (citing *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494 (1986), and *Kelly v. Robinson*, 479 U.S. 36 (1986)). In *Midlantic*, the Court held that the trustee may not abandon polluted land in violation of state health and safety laws, 474 U.S. at 507, even though the Code empowers the trustee to "abandon any property of the estate that is burdensome." 11 U.S.C. § 554(a). The trustee had lacked this power before the Code's enactment in 1978. Emphasizing that "if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific," the Court concluded that the Code and its history

did not do so. *Midlantic*, 474 U.S. at 501 (citation omitted). In *Kelly*, the Court adhered to this guidance, holding that a criminal restitution order is not dischargeable in a chapter 7 bankruptcy. 479 U.S. at 50. The Court examined the longstanding pre-Code rule against discharging criminal sentences and noted its reluctance to hold that the Code "silently abrogated" this prior practice, particularly given the strong federalism concerns that would arise from bankruptcy court review of state criminal sentences. *Id.* at 44-47; *cf. McElroy v. United States*, 455 U.S. 642, 658 (1982) ("absent a clear statement of purpose from Congress, the Court was unwilling to read a federal criminal statute in a way that would encroach on a traditional area of state criminal jurisdiction").

The Court long ago refuted any suggestion that *Midlantic* and *Kelly* should be read to hold that pre-Code practices can alter the plain meaning of unambiguous Code provisions. In *Ron Pair*, the Court explained that *Midlantic* "did not rest solely, or even primarily, on a presumption of continuity with pre-Code practice." 489 U.S. at 244. Instead, *Midlantic* rested on the conflicts that an unlimited abandonment power would have created with other Code provisions, the "extraordinary" nature of the trustee's claimed power, and national environmental policy. *Id.* Likewise, *Ron Pair* explained that *Kelly* did not rely on a "pale presumption" of continuity with pre-Code practice. *Id.* at 245. Rather, *Kelly* used pre-Code practice as an "aid" to interpret an ambiguous provision against the backdrop of the overriding federal policy against interfering with state criminal proceedings. *Id.* at 244.

More important, *Ron Pair* read *Midlantic* and *Kelly* to limit the use of pre-Code practice as an interpretive tool to cases satisfying two conditions. First, the statutory language

must be "open to interpretation." *Id.* at 245. Second, the case must "involve[] a situation where bankruptcy law, under the proposed interpretation [breaking with pre-Code practice], [is] in clear conflict with state or federal laws of great importance." *Id.* Both *Midlantic* and *Kelly* satisfied these conditions. *Id.* at 244-45. But applying this test in *Ron Pair*, the Court rejected a pre-Code bankruptcy court practice, holding instead that the Code unambiguously authorized a nonconsensual oversecured creditor to claim post-petition interest. *Id.* at 240-42.

This analysis not only harmonizes *Midlantic* and *Kelly* with *Ron Pair*, but also explains later decisions. In *Pennsylvania Department of Public Welfare v. Davenport*, 495 U.S. 552 (1990), for instance, despite the undisputed pre-Code practice of not discharging criminal sentences in bankruptcy, the Court held that the Code's plain text made criminal restitution orders dischargeable in a chapter 13 bankruptcy. *Id.* at 563-64. Similarly, the Court has declined to consider pre-Code practice where the Code unambiguously allows only the trustee – not a creditor – to recover certain expenses. *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 10-11 (2000). The *Ron Pair* analysis also accounts for *Dewsnup v. Timm*, 502 U.S. 410, 420 (1992), which followed pre-Code practice to hold that the Code prohibits a debtor from reducing a creditor's lien to its judicially determined value, because the statutory text was ambiguous and the proposed interpretation conflicted with the "basic bankruptcy principles" that a lien passes through bankruptcy and that the debtor should not receive a windfall from a creditor.

Pre-Code practice therefore cannot alter the meaning of Section 510(a) under *Ron Pair*. As these cases demonstrate, pre-Code practice "cannot overcome [the Code's]

language. It is a tool of construction, not an extratextual supplement." *Hartford Underwriters*, 530 U.S. at 10. Where the Code is unambiguous – as in Section 510(a) – the Court's inquiry ends regardless of pre-Code practice. And even if Section 510(a) were ambiguous, it still would be inappropriate under *Ron Pair* to resort to pre-Code practice, given that the First and Eleventh Circuits' interpretation does not conflict with any important state or federal law or policy, much less ones as important as environmental protection and federal-court abstention from state criminal proceedings. In short, despite Petitioners' contrary suggestion, this Court's precedents reinforce the uniform textual analysis of the courts of appeals: Section 510(a) abrogated the pre-Code equitable Rule of Explicitness.

c. While they admit that both First and Eleventh Circuits have rejected their claim, Petitioners assert that "leading authorities have recognized" that the pre-Code Rule of Explicitness "was not displaced by the enactment of Section 510(a)." Pet. 18-19 (citing a treatise, a law review article, and three bankruptcy court decisions). With one arguable exception, however, none of the authorities cited by Petitioners say that Section 510(a) incorporates the pre-Code ~~equitable~~ Rule of Explicitness. Instead, they merely support the uncontroversial proposition that under Section 510(a) subordination agreements continue to be enforceable in bankruptcy, as they were under pre-Code equitable practice. *See, e.g.*, 4 COLLIER ON BANKRUPTCY ¶ 510.03[2] (15th rev. ed. 2003). COLLIER, for example, is agnostic on the question whether the Rule of Explicitness survived enactment of Section 510(a), noting merely what "[s]ome courts" have held. COLLIER, *supra*, at ¶ 510.03[3] & n.14. But the only post-Code decisions it identifies are the

bankruptcy court decision below, the opinions culminating in the Eleventh Circuit's decision in *Southeast*, and *First Fidelity Bank, N.A. v. Midlantic National Bank (In re Ionosphere Clubs, Inc.)*, 134 B.R. 528 (Bankr. S.D.N.Y. 1991), also relied upon by Petitioners.

Only *Ionosphere* even arguably supports the proposition that the pre-Code equitable Rule of Explicitness was codified by Section 510(a), and the court there noted that one might argue that the Rule of Explicitness "is inconsistent with § 510(a)," but held otherwise largely because the parties failed to dispute the point. *Ionosphere*, 134 B.R. at 533-34. This lonely bankruptcy court ruling, made before the First and Eleventh Circuits' uniform rulings that Section 510(a) abrogated the pre-Code equitable Rule of Explicitness, does not create a division in authority warranting this Court's review.*

2. The First and Eleventh Circuits disagree only on the narrow question of whether the bankruptcy-only Rule of Explicitness adopted by the New York Court of Appeals in *Chemical Bank* governs interpretation of subordination agreements as "applicable nonbankruptcy law" under Section 510(a). This shallow conflict over which provision of New York state law applies in these circumstances does not warrant review by this Court because it was correctly decided below, this Court does not ordinarily decide

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* Petitioners point out that the pre-Code decisions by the Tenth, Second, and Third Circuit have not been overruled, *see* Pet. 19, but nor have they been re-affirmed. Simply put, those circuits, as well as all but two of their sisters, have not been presented with the question whether the equitable Rule of Explicitness survived enactment of Section 510(a). The dearth of precedent over the past quarter century on this issue demonstrates that this Court's review is not required – the question simply does not come up very often.

questions concerning which provision of state law governs even where the issue is technically a federal question, the question rarely arises, and it has little practical significance.

a. Under Section 510(a), the bankruptcy court must enforce subordination agreements according to "applicable nonbankruptcy law." This language is not subtle or challenging. *See Patterson*, 504 U.S. at 757-59; *id.* at 766 (Scalia, J., concurring). It directs the court to apply to subordination agreements the law that would apply outside bankruptcy. Because those agreements are contracts, "applicable nonbankruptcy law" is generally applicable state contract law.

In *Chemical Bank*, however, the New York Court of Appeals adopted a bankruptcy-only rule: "In accordance with the Rule of Explicitness, New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's *post-petition interest demand*." 93 N.Y.2d at 186, 710 N.E.2d at 1088, 688 N.Y.S.2d at 489 (emphasis added). As the First Circuit correctly explained, this rule's bankruptcy-only nature "is apparent from its use of the term 'post-petition interest' – a term of art applicable only in bankruptcy." Pet. 15a.

The New York court further emphasized that its ruling was limited to the context presented by the question certified to it by the Eleventh Circuit. It recognized the Rule of Explicitness only "for purposes of answering this question – in the spirit of comity but also with the usual certification constraints, as well as within the confines of interrelated threshold rulings already made by the Eleventh Circuit." 93 N.Y.2d at 186, 710 N.E.2d at

1087, 688 N.Y.S.2d at 489. By its terms, the rule announced in *Chemical Bank* requires "a heightened degree of clarity only if the effort to enforce [subordination agreements] ar[ises] in bankruptcy rather than in some other context." Pet. 13a. In short, *Chemical Bank* announced a bankruptcy-only rule.

Because the *Chemical Bank* rule applies only in bankruptcy, it cannot be "*non*bankruptcy law" under Section 510(a). To apply a special, bankruptcy-only rule to subordination agreements in bankruptcy court "would go well beyond the intended reach of section 510(a)," which enforces subordination agreements identically in and out of bankruptcy. Pet. 13a. Indeed, even if the bankruptcy-only Rule of Explicitness crafted by the New York Court of Appeals had been enacted by the State's legislature, it still could not govern interpretation of subordination agreements under Section 510(a).

The First Circuit has not, as Petitioners claim, "usurped the authority of the New York Court of Appeals to act as the final arbiter of its own state law." Pet. 14. Instead, it merely interpreted a federal statute according to its plain language, holding that "applicable nonbankruptcy law" does not include laws applicable only in bankruptcy. The court went out of its way to emphasize its deference to the prerogative of the New York Assembly and the New York Court of Appeals to adopt whatever law they see fit with respect to the enforceability of subordination agreements, provided only that such law be applicable generally and not merely in bankruptcy – that is, provided only that it be "applicable nonbankruptcy law." Pet. 16a. This case does not raise any question of federal-state comity, but instead a question of federal statutory interpretation, and a simple one at that.

b. Moreover, the narrow question on which the First and Eleventh Circuits have divided arises very rarely, and rarer still is the case whose outcome is controlled by whether the court applies the Rule of Explicitness. A host of disparate circumstances must converge for the question to matter: (i) the senior and junior creditors of a common debtor must have entered a subordination agreement with language that arguably, though not explicitly, provides for the payment of the senior creditors' post-petition interest; (ii) the agreement must be governed by New York law; (iii) the debtor must file for bankruptcy; (iv) the bankruptcy estate must have enough resources to pay senior creditors their full principal and pre-petition interest, as well as all secured claims, the estate's fees and expenses, and enough additional assets to make the contest between the senior creditors' post-petition interest and the junior creditors' principal and pre-petition interest worth fighting; and (v) at the same time, the estate must not have enough resources to pay both the senior creditors' principal and pre- and post-petition interest and the junior creditors' principal and pre-petition interest in full, thus obviating any dispute. Not surprisingly, this combination of circumstances, each necessary for the question dividing the First and Eleventh Circuits to arise and matter, rarely comes together in a single case – in the quarter century since the Code was enacted, the question has reached a court of appeals only twice, and *Ionosphere* is the only other post-Code case cited by Petitioners that squarely addresses the question.

c. In addition to its rarity, this question also has little practical significance. Petitioners claim that the decision below "threatens to send a tidal wave of uncertainty through the settled financial expectations in [the]

vast sea" of subordination agreements by "throw[ing] into doubt hundreds of billions of dollars worth of bond offerings." Pet. 2, 14. With these calamities looming, one might have expected the Nation's financial press to take some notice of the First Circuit's ruling, but we have been able to find no article in any significant business publication, and Petitioners cite none, informing the investing public of the decision, much less its supposed catastrophic consequences. This silence is telling.

Moreover, the practical implications of the decision for future subordination agreements are virtually nil. Petitioners correctly note that financial-market participants may contract around a legal rule, whether that rule is sound or not. Pet. 23-24. Just so. Going forward, market participants may easily contract around both the First and the Eleventh Circuits' decisions by adding a single unambiguous phrase to their subordination agreements – "including post-petition interest" or "excluding post-petition interest," depending on their intent.

Further, to the extent that some market participants did not consider the issue to be sufficiently important to merit explicit treatment in a subordination agreement, it can hardly be said that their expectations would be frustrated, regardless of which rule of construction is applied. In those rare circumstances, the First Circuit's conclusion in this case – a remand for factual finding to determine whether the parties intended to cover post-petition interest – hardly threatens to convulse the capital markets in this country. This largely academic question, which will affect resolution of a tiny – perhaps null – set of cases, simply does not merit this Court's attention.

3. Finally, the petition is premature because the decision below is interlocutory. The First Circuit did not finally resolve this controversy, but instead remanded for factual findings as to the parties' intent. For more than a century, this Court has "generally await[ed] final judgment in the lower courts before exercising [its] certiorari jurisdiction." *Virginia Military Inst. v. United States*, 508 U.S. 946, 946 (1993) (opinion of Scalia, J., respecting denial of the petition for writ of certiorari); *see also American Constr. Co. v. Jacksonville, Tampa & Key West Ry. Co.*, 148 U.S. 372, 384 (1893); *Hamilton-Brown Shoe Co. v. Wolf Bros. & Co.*, 240 U.S. 251, 258 (1916); *Brotherhood of Locomotive Firemen & Enginemen v. Bangor & Aroostock R.R. Co.*, 389 U.S. 327, 328 (1967). In this case, it is entirely possible that the parties' dispute over whether the Rule of Explicitness should govern interpretation of the subordination agreements will be unnecessary to resolution of the underlying controversy. If the bankruptcy court finds on remand that the parties did not, in fact, intend for the senior creditors to recover post-petition interest, the parties' disagreement over the applicability of the Rule of Explicitness will not control the outcome.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

September 7, 2004

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IN THE

Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION, CHASE MANHATTAN BANK, USA, NATIONAL ASSOCIATION, as Indenture Trustees, and DR. BEN S. BRANCH, Chapter 7 Bankruptcy Trustee,

Petitioners,

v.

HSBC BANK USA and JPMORGAN CHASE BANK, as Indenture Trustees,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

The corporate disclosure statement for Petitioners was set forth at page *iii* of their Petition for a Writ of Certiorari, and there are no amendments to that statement.

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Respondents' attempt to characterize the important issues before this Court as "largely academic," (Br. in Opp. at 18), stands in stark contrast to the frank description offered by the highest court of the state in which the financial capital of the nation is located:

> [W]e are acutely cognizant of the practical effect that our answer to the certified question will have on a vast sea of subordination agreements not before us now in live cases or controversies, nor even within the framework of this . . . litigation, involving enormous sums of oustanding public debt. . . . This practical policy consequence is a matter of legitimate concern . . . especially with respect to commercial matters where reliance, definiteness and predictability are such important goals of the law itself, designed so that parties may intelligently negotiate and order their rights and duties.

Chemical Bank v. First Trust of New York, Nat'l Ass'n (In the Matter of Southeast Banking Corp.), 710 N.E.2d 1083, 1086 (N.Y. 1999).

The practical and legal effects of the First Circuit's decision are profound, far-reaching, immediate, and—should this Court deny review—irremediable. For all of these reasons, this Court should grant review, and should do so now.

1. The First Circuit Departed from 30 Years of Judicial Practice. Respondents seek to minimize the significance of the First Circuit's decision by suggesting that the question of the continued efficacy of the Rule of Explicitness "has arisen in only one other court of appeals decision in the quarter century since the Code's enactment." Br. in Opp. at 3. Rhetoric aside, what Respondents characterize as a "dearth of precedent" (*id.* at 14) in fact reflects the uncontroverted and uniform application of the Rule. Respondents' statement that "the question simply does not come up very often," Br. in Opp. at 14, is true precisely because neither parties nor courts have challenged the vitality of the Rule. Respondents' observations

thus merely underscore the Rule's well-established status as a universally-applied interpretative canon. They also underscore the First Circuit's dramatic departure from well-settled law by declaring that the Rule is dead. No court, until the First Circuit, has ever refused to apply the Rule—in one form or another.[1]

The historical fact is that, contrary to Respondents' contention, the Rule of Explicitness was not displaced as a canon of federal common law until the Eleventh Circuit issued its *Southeast Banking Corp.* decision in 1998.[2] As noted in the Petition (Pet. at 14), the practical effect of that decision was mitigated by the Eleventh Circuit's application of New York's version of the Rule. Accordingly, until the First Circuit issued its decision in April 2004, the Rule of Explicitness had consistently been applied—in one form or another—for thirty years.

But this Court need not take Petitioners' (or Respondents') word for it. As of 1999, two decades after the enactment of § 510(a) in 1978, the Rule of Explicitness was so well-established that the New York Court of Appeals (in response to certification from the Eleventh Circuit) made the following observation:

> Parties to subordination agreements undoubtedly relied on the Rule—their lawyers would have been quite remiss had they not—since recent case law, as

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1. Indeed, until their about-face in the Brief in Opposition, Respondents themselves never challenged the existence or application of the Rule of Explicitness. *See, e.g.*, Senior Indenture Trustees' Reply Brief in Support of Their Appeal from Order Authorizing Fourth Interim Distribution at 2, *In re Bank of New England Corp.*, 295 B.R. 419 (D.Mass. 2003) (No. 01-12229) ("There is no dispute among the parties that . . . New York law has adopted its version of the Rule of Explicitness—which requires specific language in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of allowing the payment of a senior creditor's post-petition interest demand . . . .").

2. *Chemical Bank v. First Trust of New York, Nat'l Ass'n (In re Southeast Banking Corp.)*, 156 F.3d 1114, 1122 (11th Cir. 1998).

> well as a leading authority and many commentators have consistently recognized the continued vitality of the Rule.

In the Matter of Southeast Banking Corp., 710 N.E.2d at 1086 (citations omitted); *see also In re Southeast Banking Corp.*, 156 F.3d at 1124 (inquiring "whether the New York courts would disturb the heretofore uniform treatment of this question, particularly given the evidence that the capital markets appear to have adjusted to the Rule of Explicitness"). Accordingly, there is no gainsaying that the First Circuit's refusal to apply the Rule (in either its federal or state law form) reflects an abrupt departure from three decades of nationally uniform jurisprudence.

2. The First Circuit Ignored This Court's Rule of Preservation of Prior Judicial Practice Absent Contrary Congressional Intent. There is also no gainsaying the fact that the First Circuit did not heed this Court's well-established interpretive rule that pre-Code judicial practice is to be regarded as preserved, absent specific contrary Congressional intent. Respondents concede this Court's practice applies at least when ambiguous provisions of the Code are at issue (Br. in Opp. at 10), but then simply assume away any ambiguity in the phrase "applicable nonbankruptcy law" by dismissing the language as "not subtle or challenging." *Id.* at 15. Once again, Respondents succeed only in hoisting themselves on their own rhetorical petard. Although they acknowledge (Br. in Opp. at 9) that this Court has construed the phrase as used throughout the Code "to include federal as well as state law," *Patterson v. Shumate*, 504 U.S. 753, 758 (1992), they then deny that this particular use of it encompasses federal common law rules of construction and further assert that it extends only to certain state laws – apparently those which might be deemed by the First Circuit to be of sufficiently "general" application. They are wrong in those assertions, as discussed below, but their very need to make them underscores their need to have the phrase be ambiguous: capable of one meaning in the context of *Patterson v. Shumate* and

another here. And that fact itself underscores the importance of examining pre-Code practice in this case, and of following this Court's interpretative principles regarding the same, which the First Circuit failed to do.

3. The First Circuit's Limitation of "Applicable Nonbankruptcy Law" to "Generally Applicable State Rules of Contract Interpretation" Is Wrong. The First Circuit's limitation of "applicable nonbankruptcy law" to "state law (and, particularly, state contract law)," Pet. App. at 11a, contravenes this Court's refusal so to circumscribe Congress' intent in using the phrase. *Patterson*, 504 U.S. at 758 ("The Code reveals, significantly, that Congress, when it desired to do so, knew how to restrict the scope of applicable law to 'state law' and did so with some frequency.").[3]

To begin with, the First Circuit (and the Eleventh Circuit before it) misapprehended the congressional purpose (and thus the federal interest) involved. Congress explicitly codified previously accepted bankruptcy principles regarding both the suspension of post-petition interest to, and the equitable, *pro rata* allocation of bankruptcy assets among, unsecured creditors. *See, e.g.*, 11 U.S.C. §§ 502(b)(2), 726(b). At the same time, Congress recognized (a) the ability of such creditors to reallocate among themselves—by contractual agreements outside of bankruptcy—the recoveries to which they would otherwise be

3. In his concurrence in *Patterson* (which Respondents cite, Br. in Opp. at 15), Justice Scalia observed:

> When the phrase 'applicable nonbankruptcy law' is considered in isolation, the phenomenon that three Courts of Appeals could have thought it a synonym for 'state law' is mystifying. When the phrase is considered together with the rest of the Bankruptcy Code (in which Congress chose to refer to state law as, logically enough, 'state law'), the phenomenon calls into question whether our legal culture has so far departed from attention to text, or is so lacking in agreed-upon methodology for creating and interpreting text, that it any longer makes sense to talk of 'a government of laws, not of men.'

504 U.S. at 766 (Scalia, J., concurring).

entitled from a debtor in bankruptcy, and (b) that pre-Code federal judicial practice permitted such agreements but had developed rules governing the circumstances under which they would be enforced despite the usual rules (of no post-petition interest and strict pro-rata distribution). Rather than simply outlawing such agreements, Congress determined to continue to permit them, but it also both explicitly empowered bankruptcy courts to enforce them and instructed them to do so "in accordance with applicable nonbankruptcy law." Far from turning their enforcement into a free-for-all dependent on the laws of the 50 states, it is clear that Congress envisioned the uniform enforcement of such agreements according to the rules which had previously been developed, and there is nothing in the language of the Code or its history to suggest otherwise.

Even if this federal interest were disregarded, the First Circuit's distortion of "applicable nonbankruptcy law" as meaning only "generally applicable state rules of contract interpretation," Pet. App. at 12a, would still be clearly wrong. By use of the phrase "applicable nonbankruptcy law" (which appears in at least 17 different sections, and numerous subsections, of the Bankruptcy Code),[4] Congress must necessarily have intended to encompass "any relevant nonbankruptcy law." *Patterson*, 504 U.S. at 759. Stated differently, when Congress explicitly empowered *bankruptcy* courts to apply *nonbankruptcy* law, it knew they would be doing so in a bankruptcy "context" but not as part of the underlying bankruptcy itself; i.e., they would be dealing with circumstances occasioned by the bankruptcy filing, but not legally part of it.[5]

4. *See* Sections 101(35A)(F); 108(a), (b), (c); 363(f)(1); 365(c)(3), (h)(1)(A)(i), (h)(1)(A)(ii), (h)(1)(C), (h)(2)(A)(i), (h)(2)(A)(ii), (n)(1)(A), (n)(1)(B), (n)(1)(B)(ii), (n)(2)(C)(i), (n)(4)(A)(ii); 522(b)(2)(B); 524(c); 541(c)(1), (c)(2); 552(b)(1); 723(a); 927; 943(b)(6); 1123(a), (d); 1125(d); 1126(b)(1); 1142(a); 1222(d); and 1322(c), (c)(1), (e).

5. The First Circuit failed to appreciate the distinction between rules which (like New York's version of the Rule of Explicitness) are triggered **by** the filing of a bankruptcy case, and rules that apply only **in** bankruptcy.

Contrary to Respondents' contention, therefore, the language must broadly encompass—as this Court itself has determined—all "relevant" laws which exist independently from, and outside of, the Bankruptcy Code, whether they be of general or specific application, and whether or not their application is triggered by the fact that a bankruptcy has occurred.

Indeed, if left undisturbed, the First Circuit's decision will have a wide-reaching impact on 'bankruptcy-specific' state laws which hitherto have rightly been considered "applicable nonbankruptcy law." *See* D. Schechter, *'Rule of Explicitness' Governing Subordination Agreements Is Invalid As 'Bankruptcy-Only' State-Created Rule*, 2004 Com. Fin. Newsl. 32 (May 3, 2004) (recognizing "far-reaching effect [of First Circuit's decision] on many state statutes and rules of decision that purport to take effect upon the bankruptcy of a party," noting, in particular and by way of example, the invalidation of the Uniform Partnership Act's "bankruptcy-only" dissolution rule under the First Circuit's analysis, and warning of "many other examples of this same phenomenon").

4. The First Circuit Usurped the Authority of the New York Court of Appeals to Define Its State's Law. Respondents' only attempted justification of the First Circuit's refusal to acknowledge the Rule of Explicitness as part of New York state contract law, despite the express declaration by the New York Court of Appeals that the Rule *is* part of its state's law, is to repeat what the First Circuit itself said: that it would be happy to apply any state law requirement of explicitness that is a "nonbankruptcy law." *Cf.* Br. in Opp. at 16. But that promise is empty in this context. Any law which references "post-petition interest" is impermissible in the eyes of the First Circuit, because that is a "bankruptcy" term. The Rule of Explicitness, however, requires the express use of that very term, thus providing certainty to all involved. So, what the First Circuit—and now Respondents—are saying is that New York cannot have a Rule

of Explicitness that is in fact "explicit": it can only have one that is more vague, and thus less certain of application. This is defended by Respondents as merely being the First Circuit's interpretation of a federal statute, *cf.* Br. in Opp. at 16, but there is no indication that Congress intended to change the requirements of the Rule in order to favor uncertainty, or to prevent States from using certain words in their own laws.

5. The Questions Presented Are Important. This Court has never based the exercise of its certiorari jurisdiction on the number of cites to media coverage. Nonetheless, Respondents raise as a reason for denying the writ their inability to find mention of the ruling "in any significant business publication." Br. in Opp. at 18. Contrary to Respondents' statement, the First Circuit's decision, despite its recency,[6] has indeed been noted by the commentators, who have acknowledged both the unprecedented nature of the decision as well as its profound impact. *See, e.g.*, H. Strickon et al., *Theory Shifts on Rule of Explicitness*, 231 N.Y. L.J. 9 (Aug. 9, 2004) ("In holding New York's bankruptcy specific 'Rule of Explicitness' unenforceable, the First Circuit in Bank of New England Corp. reached a conclusion that is at odds with both the result and tenor of Southeast Banking Corp."); *1st Cir. Says Post-Petition Interest May Not Be Paid Under N.Y. Law*, 10 No. 1 Andrews' Bank & Lender Liab. Litig. Rep. 9 (June 7, 2004) (recognizing that First Circuit's decision "creat[ed] a split among the federal appellate courts" on "an issue of first impression"); Schechter, *supra*, at 32 (recognizing "far-reaching effect [of First Circuit's decision] on many state statutes and rules of decision that purport to take effect upon the bankruptcy of a party"); *Rule of Explicitness Was Inapplicable in Bankruptcy*, 04-28-04 West's Bankr. Newsl. 7 (Apr. 28, 2004) (acknowledging First Circuit's decision as "[a]ddressing an issue of apparent first impression in the circuit. . . .").

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6. The First Circuit issued its opinion on April 13, 2004, and denied a petition for rehearing *en banc* on May 5, 2004.

Actually, the silence which is most telling is Respondents' own. Respondents cannot—and thus do not—contest that the First Circuit has fostered an irreconcilable circuit and state court conflict, and that hundreds of billions of dollars of subordinated debt issues are affected as a result. Nor have Respondents addressed the discordant results which will ensue when courts within the First Circuit are prohibited from applying the Rule, while courts within the Eleventh Circuit are required to apply it.[7] Respondents have also not confronted the commercial uncertainties created by the First Circuit's decision. Respondents' only proposed solution—that market participants "add[] a single unambiguous phrase to their subordination agreements—'including post-petition interest' or 'excluding post-petition interest,' depending on their intent" (Br. in Opp.

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7. Respondents also ignore the surge of litigation which will now arise as a result. The First Circuit's decision stands as an invitation to senior subordinated creditors to challenge less-than-explicit language which previously would simply have failed the Rule:

> For a litigator, Bank of New England Corp. may represent a shift in the landscape of [a] case[ ] regarding the availability through a subordination agreement of postpetition interest which would otherwise be unavailable under the Bankruptcy Code. It now appears that the absence of 'explicit' language providing for such interest will not necessarily be fatal to a senior creditor's claim. Instead, such language will likely be viewed as 'ambiguous' and the crux of contested cases will shift from whether language is 'explicit' to a more fact-intensive inquiry regarding the parties' intent.

See Strickon, *supra*, at 9. So, too, will the First Circuit's decision encourage parties seeking application of the Rule to commence actions in the state courts of New York, thus defeating the congressional purpose served by empowering bankruptcy courts to enforce subordination agreements in the first place—the uniform resolution of bankruptcy and non-bankruptcy issues in one forum.

at 18)—even if tenable,[8] would provide no certainty to the vast multitude of parties to existing agreements, who have already relied on the presence or absence of the phrase—and the effect thereof under the Rule—in structuring their commercial transactions, as the New York Court of Appeals has recognized. *In the Matter of Southeast Banking Corp.*, 710 N.E.2d at 1086.

6. The Questions Presented Are Ripe for Review Now. Respondents suggest that "the petition is premature because the decision below is interlocutory." Br. in Opp. at 19. But Respondents' reference to general practices is merely an attempt to distract from the realities of this case, realities of the sort which have long led this Court to grant review in similar procedural circumstances.

As Respondents readily concede (Br. in Opp. at 6), the First Circuit properly construed the subordination language as ambiguous, as did all the courts below it: "[W]e find the subordination provisions ambiguous as to whether they provide for the priority payment of post-petition interest." Pet. App. at 21a. Since only language which is sufficiently "precise, explicit and *unambiguous*" satisfies the Rule of Explicitness, had the First Circuit applied New York's version of the Rule—as it was bound to do—the First Circuit's finding of ambiguity would have ended the inquiry and determined the outcome in favor of Petitioners. That is, of course, what the Rule of Explicitness was designed to do. Under the Rule, Petitioners would not be subjected to "differential factfinding." The Rule of Explicitness was designed to obviate the very sort of "relief" fashioned by the First Circuit in this case. Its remand to the Bankruptcy Court to conduct "differential factfinding" thus deprives Petitioners of the very certainty and predictability of the Rule on which they relied. Even were the Petitioners ultimately to prevail on remand, the damage would already be done. *See* Strickon, *supra*, at 9. ("After all, . . . a lengthy and uncertain legal battle

8. Given the First Circuit's aversion to enforcement of any state law which would explicitly give effect to the use of such a "bankruptcy" phrase, there is no reason to think Respondents' proposed "solution" would solve the problem the First Circuit has created.

over the intent of the parties to a subordination agreement regarding such interest is hardly a victory *regardless of the outcome*.") (emphasis added). Thus, it is no answer to speculate that the Bankruptcy Court may eventually determine "that the parties did not, in fact, intend for the senior creditors to recover post-petition interest." Br. in Opp. at 19. The First Circuit's refusal to apply the Rule of Explicitness is a present injury which cannot be remedied on remand and, in fact, will never be remedied if the Court denies review. Review of that refusal is thus ripe now.

Moreover, and most importantly for this Court, were the Petitioners to prevail on remand, the First Circuit's improper abrogation of the Rule as a federal interpretative canon, its improperly narrow construction of the phrase "applicable nonbankruptcy law," and its refusal to follow New York state law as expressed by its highest court, would remain undisturbed, the status of the Rule would remain conflicted between the First and Eleventh Circuits and uncertain elsewhere, and all the concomitant problems associated with that uncertainty (*see, e.g.*, Pet. at 22-24) would remain. Review now is thus not only appropriate because the questions are ripe, but because their resolution is, and will remain, important.

This Court has long recognized that it can, and should, resolve important conflicts between federal courts of appeals, or between a federal court of appeals and a state's highest court, where the reasons for granting review will not be affected by the pending remand. *See, e.g., United States v. General Motors Corp.*, 323 U.S. 373, 374, 377 (1945); *Forsyth v. City of Hammond*, 166 U.S. 506, 511-515 (1897). This is just such a case, and, accordingly, the important questions presented should be resolved now.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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